2000

CPA's guide to marriage, divorce and family taxation

William J. Lindquist

William H. Olson

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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1 2 3 4 5 6 7 8 9 0 PP 0 9 8 7 6 5 4 3 2 1 0

ISBN 0-87051-304-4

FOREWORD

In this day and age of fierce competition in the accounting profession, many CPAs are finding niches in "growth" areas to provide clients with specialized services. For many social, economic and tax reasons, accounting practitioners providing divorce-related expertise are experiencing such growth. CPAs providing divorce-related services do so on a single engagement basis or as part of a traditional accounting practice offering tax services for divorcing clients. Practitioners providing single engagement services generally assist the divorce attorney with financial analysis, performing forensic examinations and testifying as an expert witness.

Although most people make their personal lifestyle choices for personal reasons, those decisions have a major impact on people's tax and financial status. This publication examines the tax consequences of a marriage's life cycle, from planning marriage, to raising a family, through the end of the marriage due to divorce, separation or death.

Written by two experienced tax practitioners, it is full of examples that illustrate the principles of family taxation. You are likely to reach for this publication often for reference as you encounter different clients and need to understand the effects of choices they have already made, or try to explain to them how to plan for the best possible tax outcomes of the choices they are thinking about.

We are grateful to the authors, William J. Lindquist, CPA, Vice President and Tax Director of Valhi, Inc., a Fortune 500 company, and William H. Olson, Ph.D, CPA. We would also like to thank Barbara Weltman, Esq., an attorney in Millwood, New York, for her careful technical review of the material.

Linda Prentice Cohen
Professional Publications & Technology Products

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INTRODUCTION

This publication examines the tax consequences of a marriage's life cycle, from considering to marry, to raising a family, through a potential legal separation or divorce, to the ultimate death of one of the marital parties. Whether a couple should marry, stay married or divorce are questions outside the realm of the tax law. However, understanding the tax effects when a couple marries, stays married or divorces are questions that *A CPA's Guide to Marriage, Divorce and Family Taxation* attempts to answer.

We would like to share how we approached writing this publication. We are both practicing CPAs working entirely in the tax area. We are engaged by clients and colleagues to help counsel and plan for individuals considering marriage, separation or divorce. Therefore, this publication is written from a practitioner's viewpoint, highlighting and discussing common transactions, pointing out potential pitfalls and planning opportunities, and discussing the taxpayer's filing requirements. Each discussion is clearly referenced and fully cited for further research. A summary of the topics covered in each chapter and a discussion of the CPA's role in the divorce process follow.

CHAPTER OVERVIEWS

Chapter 1 — Tax Considerations in Getting Married

A marriage is generally a personal event, usually free of any business and tax considerations. Although individuals rarely think about the tax impact of marriage, a taxpayer's marital status can drastically impact his or her tax liability. An individual's marital status determines the tax rate and the availability and limitation of certain expenses and credits. Although married taxpayers filing a joint return may pay tax at a lower tax rate, the Code generally penalizes joint return filers through the marriage penalty tax. The marriage penalty tax results in married taxpayers filing jointly paying more tax than the taxpayers would have paid on a combined basis as two unmarried taxpayers. Although the marriage penalty tax rarely changes a couple's decision to marry, it should be considered in determining the timing of the wedding.

Once it is decided that a couple will marry, the parties may want to plan for possible contingencies, especially the marriage's end due to legal separation, divorce or death. Using a prenuptial agreement for planning allows the contracting parties the peace of mind of knowing how their marital rights and assets will be divided if such a contingency occurs.

Chapter 2 — General Tax Consequences of Ending a Marriage

A marriage may be ended by:

- Legal separation;

- Divorce; or

- Death.

The one area in the tax law most likely to cause confusion when ending a marriage is legal separation. Separated taxpayers trying to file as unmarried individuals face uncertainty about their filing status. To file as unmarried individuals, the marital parties must qualify as legally separated for state law purposes. The definition of legal separation varies by state, but, generally, there must be a complete marital breakdown or a change in the marital relationship that makes rehabilitation impossible.

When one spouse dies, the dead spouse's executor is responsible for filing the decedent's final return. However, if certain events occur, the decedent spouse's final return may be filed by the surviving spouse. A number of factors and limitations must be considered before a determination is made.

Chapter 3 — Alimony Payments

In most states, when a divorce petition is filed (or when a legal separation starts), the spouse having the higher income has a legal obligation to provide some measure of financial support to the other spouse. Alimony (or spousal support) refers to the support payments made by one spouse to the other (or former) spouse.

Alimony is usually determined at two times during the divorce process in the form of:

- Temporary support; and

- Final support.

Temporary alimony refers to spousal support payments made between the date the divorce petition is filed and the date the divorce decree is issued. Final alimony refers to spousal support payments that are made after the divorce decree is issued.

Chapter 4 — Child Support Payments

State law requires that parents must provide support for their children until they reach the age of majority. As opposed to tax deductible alimony payments, child support payments are nondeductible because they represent personal expenses.

For payments to be classified as child support payments, the divorce decree or separation document:

- Must fix the amount paid for the support of a child;

- Must provide that the amount paid will be reduced in the event of some contingency relating to a child (such as the child marrying, dying, reaching a certain age, etc.); and

- Must provide that the amount paid will be reduced at a time which can be clearly associated with a contingency relating to a child.

Chapter 5 — Child Dependency and Custodial Issues

Child dependency and custody issues can have important tax consequences to couples thinking of divorce or legal separation. For example, the tax benefits of a taxpayer receiving custody of a child in a divorce or legal separation include the following:

- Claiming the child's dependency exemption;
- Qualifying for head of household filing status;
- Claiming the child care credit; and
- Claiming the child's medical care expenses deduction.

These tax benefits should be considered by couples negotiating divorce and separate maintenance agreements.

Chapter 6 — Spousal Property Transfers

State law generally provides that husbands and wives have interests in property acquired during their marriage, regardless of which spouse holds the property's title. Upon divorce or legal separation, these property rights may be satisfied by property divisions and cash and other property transfers, either by mutual agreement or pursuant to a court decree.

The spousal property or cash transfers are usually made directly to the spouse, but, in some cases, the transfers may be made:

- To another individual;
- To a trust; or
- To another party.

In determining whether a spousal property distribution represents a fair payment for the release of a spouse's marital rights, the transfer's current and future tax consequences must be closely analyzed.

Chapter 7 — Planning for the Tax Impact of Ending a Marriage

In ending a marriage through divorce or legal separation, the timing may, similar to the timing of a marriage, influence the taxes paid by each party in the year the marriage ends. Generally, it is advantageous for tax purposes to end a marriage prior to year-end because of the marriage penalty. The various income and tax limitations on some deductions make it beneficial to have two limitations instead of one. However, the marriage penalty must be considered along with each party's current tax situation and estate and gift tax consequences in determining the best timing for receiving a final divorce or legal separation decree.

THE CPA'S ROLE IN THE DIVORCE PROCESS

As can be seen from the chapter overviews, the majority of the material discusses the tax consequences of divorce. It is written for CPAs working in the following areas:

- CPAs offering litigation support on an independent engagement basis — many CPAs have specialized practices dealing with the financial consequences of divorces. These practitioners provide many divorce-related services, including assisting the divorce attorney with:

    - spousal and child support negotiations;
    - valuing marital property; and
    - expert witness testimony.

Many of these practitioners perform these services in lieu of a "traditional" accounting practice and offer their services on a stand-alone basis. This publication can be a useful refresher of the technical divorce-related tax rules.

- CPAs offering traditional tax services for divorcing clients — most CPAs, although not specializing in divorce work, may have an indirect involvement in divorce engagements through consultations or preparing returns. These practitioners generally do not get involved in a divorce engagement until after the divorce is final. These CPAs are primarily interested in the tax return treatment of:

    - alimony and child support payments;
    - marital property transfers and settlements; and
    - other tax related issues.

This publication provides a useful reference tool for these CPAs.

DEVELOPING A DIVORCE PRACTICE

The public accounting profession is very competitive with new CPAs establishing practices every year. Fees and margins for traditional auditing and tax work tend to suffer as competition grows. This is why many CPAs branch-out and offer clients specialties in certain accounting, tax and financial "growth" areas. A divorce services accounting practice is such a growth area, as demonstrated by the following factors:

- The U.S. divorce rate continues to climb, increasing the need for divorce-related accounting services;
- A CPA's hourly billing rate for such divorce-related accounting services is generally higher than for traditional accounting work;
- The divorce tax laws and rulings are becoming more complicated, requiring more specialization;
- Divorce lawyers are increasingly looking to CPAs for expert testimony and financial support to reduce the likelihood of legal malpractice;
- Divorce courts are requiring more detailed and accurate financial information regarding asset valuations and settlement proposals; and
- Divorce-related accounting work is not seasonal. It can be used to fill in around a CPA's busy seasons.

Overview of the Divorce Proceedings

The following steps are typically performed in a divorce engagement (the steps in **"bold"** print are ones normally performed by a CPA):

- The petitioner spouse hires an attorney and sues the respondent spouse for divorce;
- The respondent spouse receives the divorce complaint and responds within a certain timeframe;
- **Preliminary income and expense schedules for each spouse are prepared;**
- **Temporary child custody and spousal and child support are determined based on a hearing or negotiations;**
- The following "discovery" procedures are performed:
    - **Final income and expense schedules for each spouse are prepared. Additional verification may be required if there are any questions or uncertainty regarding the schedules' accuracy;**
    - **Marital and separate property balance sheets are prepared. Additional verification may be required if there are any questions or uncertainty regarding the schedules' accuracy;**

- **Marital and separate property balance sheets are prepared on a fair market value basis. Closely-held businesses may be valued independently; and**

- **Marital and separate property balance sheets are prepared on a tax basis.**

- **Tax and financial planning for each spouse is conducted;**

- **Marital property distributions are negotiated or litigated. Expert witnesses may be required to substantiate valuations if the distributions are litigated;**

- **Final child custody and spousal and child support are negotiated or litigated. Expert witnesses may be required to substantiate income and expenses if the issues are litigated;**

- The divorce is granted; and

- **Tax returns, financial and tax planning are done for each spouse.**

Most of the steps are in bold print because a CPA often works in all of these areas. However, a CPA's involvement in the divorce engagement, if not mandated by the client, is left to the attorney's discretion.

Following is a more detailed discussion of a CPA's role in each of the above steps:

Preliminary Income and Expense Schedules Are Prepared. CPAs brought in early in the divorce process will generally determine the client spouse's income sources and expected living expenses during the divorce proceedings. In addition, the CPA may be asked to verify the accuracy of such information provided by the other spouse.

The resulting schedules are used by the attorneys as a basis for negotiating temporary support payments. If negotiations are impossible, the schedules are used by the judge in deciding the appropriate amount of temporary support until the divorce is final.

Once temporary support determinations are made, it is unlikely that they will change. Therefore, divorce attorneys take this preliminary support phase of a divorce proceeding very seriously and will generally rely on the CPA to perform the necessary functions.

Discovery Procedures. One of the most important parts of any litigation is the discovery phase. The purpose of the discovery phase is to expedite litigation through the disclosure of evidence and to encourage dispute settlements. In a divorce engagement discovery phase, substantial information regarding both spouses is gathered. Some of this information relates to the spouses' character for custody issues, but the majority of the information is financial. CPAs are most often engaged to gather this type of information and report to the client divorce attorney or court. The information provided by the CPA helps the court:

- Determine the proper levels of spousal and child support payments; and

- Determine a proper settlement distribution of marital assets.

The types of discovery procedures that a CPA performs in a divorce engagement could include any of the following:

- Preparing final income and expense schedules for each spouse — the amount of spousal and child support each spouse must pay after the final divorce decree is based on each spouse's sources of income and expected expenses. The schedules the CPA prepares to document these amounts are similar to those prepared for the temporary support determination, only more detailed.

- Taxing support payments — as more fully discussed in Chapters 3 and 4, spousal support payments are deductible by the payor spouse and taxable to the receiving spouse while child support payments are neither deductible nor taxable. Therefore, there may be an incentive for one spouse to understate or overstate the type of payment made or received. A CPA is sometimes engaged to review the support decrees before they are final to ensure that the desired classification and tax treatment are reached.

- Additional verification of financial records — because so much is riding on the financial information provided by each spouse, sometimes CPAs are engaged to review the other spouse's financial records to determine the actual income and expected expenses. An investigation to verify this type of information is referred to as a "forensic examination".

- Preparing marital and separate property balance sheets — an important part of a divorce is to achieve an equitable distribution of marital property between the parties. While marital property is generally split in some fashion between the parties, separate property, which belongs to only one spouse, is generally retained by that spouse. Therefore, a CPA is often engaged to prepare the following schedules to assist in the distribution process:

    - a list of marital and separate property;

    - a fair-market value analysis of marital assets and liabilities; and

    - a tax basis analysis of marital assets and liabilities.

One of the most difficult assets to value is a closely-held business. Business valuations can require many hours of work and involve sound business judgments and significant business expertise. Many experienced CPAs can perform this work, and this function is one of the most common that a CPA performs in a divorce engagement.

Finalizing Property Distributions and Support Agreements. After the discovery process is complete and a wealth of information is gathered, the divorce attorney uses the information compiled by the CPA to negotiate final property distributions and support agreements. Although not actively involved in the negotiation process, the CPA may assist this negotiation process by:

- Preparing property distribution and support agreement proposals;

- Determining the federal, state, gift and estate tax consequences of various property distribution and support agreement proposals; and

- Preparing new schedules and computations as negotiations continue.

If negotiations break down, a CPA may be asked to serve as an expert witness to testify in court as to the procedures and processes the CPA employed to reach his or her conclusions.

Post-Divorce Tax Returns and Planning. Following the divorce, the CPA may prepare the client's tax return. Although such a return is not necessarily more difficult than prior married returns, items considered in negotiating the divorce, as discussed in Chapter 7, must be incorporated in the return. For example:

- The CPA must determine whether support payments are spousal support or child support in accordance with the tax law. As previously mentioned, spousal support payments are taxable to the receiving spouse and deductible by the payor spouse, while child support payments are neither taxable nor deductible; and

- If child dependency issues are not addressed in the final divorce decree, the CPA must determine which parent may claim a child as a dependent prior to filing the first post-divorce return (see Chapter 5 for a discussion of this issue).

Many parties following a divorce find themselves in a worse economic situation than before the divorce. CPAs can offer these individuals necessary personal financial and tax planning.

SUMMARY

A CPA's Guide to Marriage, Divorce and Family Taxation examines the tax consequences of a marriage's life cycle: from considering marriage, to raising a family, through a potential legal separation or divorce, to the ultimate death of one of the marital parties. The publication is written by practicing CPAs for practicing CPAs.

CPAs providing specialized divorce-related expertise have in recent years generally found their practices growing rapidly. These CPAs have been able to differentiate and diversify their practice and provide a product generating a higher billing rate and margin.

CHAPTER 1

TAX CONSIDERATIONS IN GETTING MARRIED

INTRODUCTION

Marital status dramatically affects a taxpayer's tax liability. An individual's marital status determines his or her tax rate and the availability and limitation of certain expenses and credits. The Code has over 30 provisions that potentially alter an individual's tax liability based on marital status. Most of these provisions attempt to increase a married couple's combined tax liability by restricting the use of certain deductions and credits based on income levels. Generally, the income level restrictions for married taxpayers are not twice the amount for individual taxpayers. So married taxpayers may be "penalized" based on their marital status and their combined income levels. This increase in a married couple's tax liability, as compared to the combined individuals' tax liability, is known as the "marriage penalty."

This chapter discusses the marriage penalty and its potential impact on a couple's decision whether to marry or when to marry. Although most couples do not consider the tax consequences of marital status when planning marriage, once a decision has been made to marry, tax consequences may affect the event's timing.

Once it has been decided that a marriage will take place, the couple may wish to plan for the marriage's possible termination on divorce or death. The planning mechanism of choice is a prenuptial agreement. Prenuptial agreements allow the contracting parties the peace of mind of knowing how their marital rights and assets will be divided on death or divorce. This chapter discusses the benefits of prenuptial agreements and their resulting tax impact.

TAX RATES

An individual's tax rate depends on his or her filing status. Filing status is determined based on a variety of factors, including an individual's marital status and dependent support. There are four filing status categories for individual taxpayers:

1. Married filing jointly and surviving spouses;
2. Head of household;
3. Individual; and
4. Married filing separately.

The Code provides graduated marginal tax rates, with the lowest rates being afforded to couples filing joint returns, followed, in descending order, by taxpayers filing head of household returns, individual returns and married couples filing separate returns. As can be seen from the category descriptions, married individuals may choose to file a joint return or separate returns.

If an individual is considered unmarried for tax purposes, he or she must file as an individual taxpayer unless the requirements for a "head of household," with its lower marginal tax rates, are met (see discussion later in this chapter). A married taxpayer with a dependent child may be treated for tax return filing purposes as unmarried and eligible for head of household status if the individual qualifies as an "abandoned spouse" (see discussion later in this chapter).

CHOOSING FILING STATUS

An individual's filing status is generally determined by law. For example, if an individual is unmarried and has no qualifying dependents, the taxpayer must file as an individual. However, as mentioned above, married taxpayers may elect to either file joint returns or separate returns.

For tax purposes, in determining whether to marry, the individuals' filing status on a stand-alone and combined basis must be considered.

MARRIED FILING JOINTLY

The following requirements must be met to qualify married taxpayers for joint return filing status:

- The individuals must be married on their taxable year's last day [§6013 (d)(1)];
- Both individuals must have the same taxable year [§6013(a)(2)]; and
- Neither individual may be a nonresident alien any time during the year [§6013(a)(1)].

Marital Status. A taxpayer's marital status is generally determined on the last day of the individual's taxable year [§7703(a)(1)]. However, if the individual's spouse dies during the year, marital status is determined at the time of the spouse's death [§7703(a)(1)]. It is not necessary for married individuals to live together during the year to qualify for married filing jointly status.

"Surviving spouses" are also entitled to married filing jointly status. A "surviving spouse" is an individual:

- Whose spouse died during one of the two preceding tax years [§2(a)(1)(A)]; and
- Who provides a household for a dependent child or stepchild that would qualify the individual for a deduction under §151 (i.e., allowing a deduction for a personal exemption) [§2(a)(1)(B)].

Example 1-1:

- Bob and Alice, who have been married for ten years, have a young son, Bill, eight years old.
- During the current year, Alice suddenly dies and Bob maintains a household and continues to support Bill.
  - Bob qualifies as a surviving spouse for the next two years and is entitled to the lower married filing jointly marginal tax rates as long as he does not remarry (if Bob does remarry during the next two years, he would, presumably, be eligible to file a joint return with his new spouse).
  - Bob and Alice may file a joint return for the current year, the year of Alice's death.

Special marital status determination is made for married taxpayers:

- Who have received an annulment;
- Who have received a divorce decree;
- Who are under a separation maintenance agreement;
- Who are abandoned spouses; and
- Who have a common law marriage.

Annulment. If a marriage is annulled from its inception, for state law purposes, the couple is considered unmarried for all previous periods and must file amended returns for all open tax periods as individuals or heads of household [Rev. Rul. 76-255, 1976-2 CB 40].

Divorce Decree. Individuals who are legally separated under a divorce decree are not considered married for tax return filing purposes [§7703(a)(1)].

Whether a couple is divorced as of year-end is determined under state law and is generally not questioned by the IRS. However, a divorce decree may be invalidated for tax return filing purposes in the following two instances:

- The decree is declared invalid in a court which has personal jurisdiction over the married couple [Rev. Rul. 67-442, 1967-2 CB 65]; or

- The IRS treats the divorce decree as a "sham." The IRS will treat a divorce decree as a "sham" when the divorcing parties have an intent to remarry, following a period of divorce, to take advantage of certain tax benefits created by the divorce [Rev. Rul. 76-255, 1976-2 CB 40]. However, couples continuing to live together, following a final divorce decree, may not be deemed married following the divorce for tax return filing purposes if there is no intent to remarry [PLR 7835076, June 1, 1978].

Separation Agreement. A married couple living apart under either (1) a separation maintenance agreement [*Domigan v. Commissioner*, 68 TC 632], or (2) a temporary support decree [*S.A. Dunn v. Commissioner*, 70 TC 361] can file a joint return. Marital status is altered for tax return filing purposes only when a court issues a decree ordering the couple to live separately.

Abandoned Spouse. In some instances, a married couple may be treated as unmarried individuals for tax purposes. This concept, sometimes referred to as the "abandoned spouse" exception, provides that a married individual:

- Who does not file a joint return;

- Whose spouse does not live with him or her for at least one-half of the year;

- Who maintains a household as a principal residence for more than one-half of the year for an unmarried dependent or stepchild that would qualify the married individual for a §151 deduction; and

- Who provides more than one-half of the home maintenance expenses

is treated as unmarried as of the taxable year's last day. However, the married taxpayer whose spouse may be treated as abandoned and, thus, as unmarried, will continue to be treated as married for tax return filing purposes [§7703(b)].

Common Law Marriage. Marital status for filing purposes is based on the law of the state in which the couple lives. If an unmarried, cohabitating couple live in a state in which common law marriages are recognized and the legal conditions are met, then the couple will be deemed married for tax return filing purposes [Rev. Rul. 58-66, 1958-1 CB 60]. If the couple's resident state does not recognize common law marriages, then the couple is not deemed married for tax return filing purposes.

The following states and the District of Columbia recognize common law marriages:

- Alabama;
- Colorado;
- Georgia;
- Idaho;

- Iowa;
- Kansas;
- Montana;
- Ohio;
- Oklahoma;
- Pennsylvania;
- Rhode Island;
- South Carolina; and
- Texas.

If a couple enters into a common law marriage in a state in which common law marriages are recognized and subsequently moves to a state in which such marriages are not recognized, they will still be treated as married.

HEAD OF HOUSEHOLD

The following requirements must be met to qualify an individual taxpayer for head of household filing status:

- The taxpayer must not be married on the last day of the taxable year [§2(b)(1)];
- The taxpayer must not be a nonresident alien any time during the year [§2(b)(3)(A)]; and
- The taxpayer must not be a surviving spouse (as defined above) [§2(b)(1)].

In addition, the taxpayer must satisfy one of the following requirements:

- The taxpayer must maintain a household for more than half the year for an unmarried descendent or stepchild, as both the taxpayer's and the unmarried descendent's or stepchild's principal residence [§2(b)(1)(A)(i)];
- The taxpayer must maintain a household for more than half the year for a dependent who qualifies the taxpayer for a §151 deduction, as both the taxpayer's and dependent's principal residence [§2(b)(1)(A)(ii)]; or
- The taxpayer must maintain a household, as his or her principal residence, for more than half the year for one or both of the taxpayer's parents who qualify the taxpayer for a deduction under §151 [§2(b)(1)(B)].

Example 1-2:

- Bob and Alice, who have been married for ten years, have a young son, Bill, eight years old.
- Early in the current year, Bob and Alice divorce, and Alice gets custody of Bill.
- Bill lives with Alice throughout the year.
  - Alice will file her current-year return claiming head of household status.

Marital Status. The method for determining the marital status of an individual qualifying for head of household filing status is the same as for married filing jointly status, with one exception. If the taxpayer is married to a nonresident alien, the taxpayer will be treated as unmarried for head of household status [Reg. §1.2-2(b)(5)].

Dependent. In situations where the taxpayer is claiming head of household status based on a dependent qualifying under §2(b)(1)(A)(ii), as discussed above, the dependent must be either a:

- Sibling or stepsibling;
- Ancestor;
- Stepparent;
- Niece or nephew;
- Aunt or uncle;
- Son-in-law or daughter-in-law;
- Father-in-law or mother-in-law; or
- Brother-in-law or sister-in-law [§152(a)].

In addition, the §151 dependency deduction must not be provided solely as a result of a multiple support agreement as provided in §152(a) (see discussion in Chapter 5); the taxpayer must actually provide for more than half the dependent's support [§2(b)(1)].

Maintaining a Household. Maintaining a household to qualify for head of household status does not necessarily equate to providing half the individual's support for the §151 dependency deduction [Reg. §1.2-2(d)]. The expenses considered in maintaining a household for head of household status include:

- Property taxes;
- Mortgage interest;
- Rent;
- Utilities;
- Maintenance or repairs;

- Property insurance; and
- Food consumed on the premises [Reg. §1.2-2(d)].

Expenses normally considered for the §151 dependency deduction which are *not* considered for head of household status include:

- Clothing;
- Education;
- Medical;
- Vacations;
- Life insurance; and
- Transportation [Reg. §1.2-2(d)].

Principal Residence. The dependent's principal residence is the place where he or she lives for more than half the year [Reg. §1.2-2(c)(1)]. However, various exceptions are provided if the dependent is temporarily absent for less than six months due to:

- Illness;
- Education;
- Business;
- Vacation;
- Military service; or
- Custody agreement [Reg. §1.2-2(c)(1)].

These temporary absences will count towards the parent's more than one-half year occupancy test if it is reasonably certain that the dependent will return and the home is maintained in anticipation of such return.

For minor children of divorced parents, it is sometimes difficult to determine which of the two parents' homes constitutes the child's principal residence for head of household return filing status. The fact that one parent has legal custody of the child is neither compelling nor sufficient as proof. For example, if one of the divorced parents has legal custody of the child, but the child lives more than half the year with the other divorced parent, the child's principal residence will be deemed to be with the noncustodial parent [*J.E. Webb v. Commissioner*, 60 TCM 1229]. However, legal custody may be important in determining head of household filing status when the child does not live with either divorced parent for more than half the year because of a qualifying temporary absence.

Tax Pointer: The fact that legal custody, in certain circumstances, may play an important role in determining head of household status gives divorcing parents an additional incentive to retain custody of their children. Therefore, in cases where divorcing couples have more than one child, strictly for tax purposes, it may be beneficial for each parent to retain legal custody for at least one child so that each parent may potentially enjoy the lower tax rate benefits of the head of household filing status.

MARRIED FILING SEPARATELY

Generally, for most married taxpayers, filing a joint income tax return results in the lowest tax liability. However, in some cases, combined taxes can be saved by each married taxpayer filing separately. Other than reducing their potential tax liability, married taxpayers may file separate returns:

- To lower state income taxes:
- Because of marital conflict or a divorce in progress;
- To keep financial obligations separate;
- Because there is joint and several liability for any tax liability on a joint return, one spouse may be unwilling to accept any potential tax liability from the other spouse; or
- Because one spouse is a nonresident alien and no §6013(g) election (i.e., to treat the nonresident alien spouse as a U.S. resident) has been made.

Sourcing Income and Deductions. For married couples to receive any tax benefit from filing on a separate basis, certain income and expense items must be allocated to the individuals. To successfully allocate particular income and expense items to one of the spouses, the income or deductions must belong to that spouse. Generally, state law will determine which income and deductions belong to individual spouses [IRS Publication 555, *Federal Tax Information on Community Property*]. The guiding state law principles are based on whether the couple resides in a:

- Common law state; or a
- Community property state.

<u>Common Law State</u>. In common law states, income belongs to the spouse who owns the income-producing asset and deductions are taken by the spouse who pays the expenditures. To successfully argue that certain expenditures should be deducted by one spouse, it must be shown that the funds for such expenditures are traceable to specific spousal accounts.

<u>Community Property State</u>. Because the sourcing rules are more complex and less uniform in community property states, fewer opportunities exist to allocate specific income and expenses to one spouse. However, certain planning opportunities do exist.

Generally, income and deductions for married taxpayers residing in a community property state are sourced one-half to each taxpayer. Income derived from one spouse's separate property can either be community or separate property, depending on the state of residence. Deductions incurred to produce community income are community deductions and are sourced one-half to each spouse. However, if an expenditure not related to income-producing property (e.g., real estate taxes on a personal residence) can be traced to a spouse's separate funds, then that spouse should take the tax deduction.

For taxpayers living in community property states, there will always be a presumption that expenditures are made from community property funds. To overcome this presumption, taxpayers should attempt to keep each spouse's separate property segregated (e.g., separate bank and brokerage accounts). However, any costs associated with maintaining the separate accounts should be weighed against the implied tax savings.

INDIVIDUAL

The final filing category is individual (technically called "unmarried individual"). When a taxpayer is unmarried and has no qualifying dependents the taxpayer is locked into filing as an individual taxpayer. As mentioned before, individual tax rates are the second highest tax rates, next to married filing separately.

MARRIAGE PENALTY

Various deductions, exemptions, taxes and credits are limited by a taxpayer's income or tax liability. An individual's marital status will potentially affect the benefits and costs of these items. These items generally increase the tax liability of a married couple filing jointly. This increase in a married couple's tax liability, as compared to the combined individuals' tax liability, is known as the "marriage penalty."

The following items that comprise the marriage penalty should be considered in determining the timing of a marriage.

INCOME TAX RATES

As we previously discussed, for most married couples, computing their tax liability on a married filing jointly basis will generally result in the lowest possible tax liability because of the lower tax rates. However, in some instances, the income tax rates may be more favorable for certain cohabitating single individuals residing in states not recognizing common law marriages than for married individuals.

The following chart demonstrates this phenomenon by allocating income between spouses/singles on the basis of traditional one-earner households (100%/0%) to the more current two income earner scenario (50%/50%). Positive numbers reflect the amount of taxes that are saved by two taxpayers filing a joint return instead of individual returns because of the lower married filing jointly rates. Bracketed numbers result when the tax is higher for a joint return and it is more beneficial for the two taxpayers to file individual returns instead of a joint return.

RATE BRACKET MARRIAGE PENALTY (TAX) BENEFIT*

	--------- Spouse's Income Allocation ---------					
Taxable Income	**100%/0%**	**90%/10%**	**80%/20%**	**70%/30%**	**60%/40%**	**50%/50%**
$ 20,000	$ —	$ —	$ —	$ —	$ —	$ —
$ 30,000	780	390	—	—	—	—
$ 40,000	2,080	1,560	1,040	520	—	—
$ 50,000	2,093	1,443	793	143	(507)	(1,027)
$ 60,000	2,149	1,313	533	(247)	(1,027)	(1,027)
$ 70,000	2,449	1,329	273	(637)	(1,027)	(1,027)
$ 80,000	2,749	1,469	189	(1,027)	(1,027)	(1,027)
$ 90,000	3,049	1,609	169	(881)	(1,027)	(1,027)
$100,000	3,256	1,656	56	(764)	(1,064)	(1,120)
$125,000	3,441	1,256	(614)	(989)	(1,364)	(1,608)
$150,000	4,576	1,426	(879)	(1,329)	(1,723)	(1,723)
$200,000	4,576	376	(1,744)	(3,288)	(4,223)	(4,223)

* Based on 1996 tax brackets. For illustration only.

The chart demonstrates that the married filing jointly tax rates produce an overall lower tax liability than for two individual filers when one of the spouses generates almost all of the taxable income. As the second spouse begins to generate 25%-30% of the combined taxable income amount, the married filing jointly rates actually produce a higher tax liability.

Example 1-3:

- Bob and Alice are deciding whether to marry by year-end to take advantage of the married filing jointly tax rates.
- Bob and Alice expect to have taxable income of $10,000 and $90,000, respectively.
  - The chart shows that the married filing jointly tax rates would save the couple $1,656 over what they would pay as individuals.

Example 1-4:

- Assume the same facts as in Example 1-3, except that Bob and Alice expect to have taxable income of $40,000 and $60,000, respectively.
  - The chart shows that the married filing jointly tax rates would cost the couple $1,064 more than if they filed as individuals.

STANDARD DEDUCTIONS

Taxpayers who do not claim any itemized deductions may reduce their adjusted gross income by a "standard deduction" amount. The standard deduction amount is determined based on a taxpayer's filing status. The applicable standard deduction amount for each filing category is as follows for 1997 [§63(c)(2)]:

- Married filing jointly $6,900
- Head of household $6,050
- Individual $4,150
- Married filing separately $3,450

These standard deduction amounts are increased by $800 for taxpayers who are over age 65 and an additional $800 for taxpayers who are legally blind. In addition, both of these $800 amounts are increased to $1,000 for taxpayers who are individuals who are not married and who are not surviving spouses [§63(f)].

Although married couples filing joint returns have a greater standard deduction amount than individual return filers, their standard deduction must shelter two incomes. The standard deduction for married couples filing joint returns is actually $1,400 less than that for two individual filers and $5,200 less than two head of household filers.

Example 1-5:

- Bob and Alice, who have been living together for three years in a state not recognizing common law marriages, each have a child from a prior marriage.
- Bob and Alice marry on January 1, 1998. Throughout the years, Bob and Alice have kept records demonstrating that each has qualified to claim head of household status.
- Both Bob and Alice should be eligible to claim head of household filing status for 1997.
  - By having this status for 1997, Bob and Alice will each claim a $6,050 standard deduction (versus a combined $6,900 standard deduction for married filing jointly tax return filers).
  - Assuming a top marginal tax rate of 36%, marrying on January 1, 1998 instead of December 31, 1997 saves the couple over $1,800 ($6,050 + $6,050 = $12,100 - $6,900 = $5,200 × 36% = $1,872) in 1997.

A married taxpayer filing as married filing separately may not use the standard deduction if his or her spouse claims itemized deductions [§63(c)(6)(A)]. Such a person must itemize, even if the total itemized deductions are less than the standard deduction.

PERSONAL EXEMPTIONS

For 1997, a taxpayer may claim a $2,650 deduction amount for himself or herself, for his or her spouse and for each qualifying dependent [§151(d)]. However, the exemption amount claimed is reduced by 2% for each $2,500 ($1,250 for married persons filing separate returns) by which the taxpayer's adjusted gross income exceeds the "threshold amount." The threshold amount is based on the taxpayer's filing status as follows for 1997:

■ Married filing jointly	\$181,800
■ Head of household	\$151,500
■ Individual	\$121,200
■ Married filing separately	\$ 90,900

As we discussed in the case of the standard deduction, married couples filing joint returns have a higher threshold amount than individual return filers, although it applies to two incomes instead of one. The threshold amount for married taxpayers filing jointly is actually \$60,600 less than the sum for two individual taxpayers and \$121,200 less than the sum for two head of household filers.

Example 1-6:

- Assume the same facts as in Example 1-5, except that both Bob and Alice have adjusted gross incomes of \$151,500.
- Assuming both Bob and Alice qualify for head of household filing status, each taxpayer will not have their \$5,300 (\$2,650 × 2) personal exemption amounts reduced.
    - If Bob and Alice had married one day earlier and elected to file their 1997 return on a joint basis, their \$10,600 (\$2,650 × 4) personal exemption amount would have been reduced by \$10,176 (\$151,500 × 2 = \$303,000 - \$181,800 = \$121,200 ÷ \$2,500 = 48 × 2 = 96% × \$10,600 = \$10,176).
    - Assuming a top marginal tax rate of 36%, marrying on January 1, 1998, versus December 31, 1997, saves the couple a combined tax amount, resulting from the increased personal exemption amount, of over \$3,600 (\$10,176 × 36% = \$3,663).

CAPITAL LOSSES

Noncorporate taxpayers may deduct up to \$3,000 (\$1,500 for married taxpayers filing separately) of capital losses against noncapital gain income. Therefore, two individual taxpayers could offset \$6,000 of capital losses in a year, versus the \$3,000 limitation for married couples.

Example 1-7:

- Bob and Alice are planning to marry either at the end of 1997 or the beginning of 1998.
- During 1997, Bob and Alice had a difficult year in the stock market, with each generating $3,000 in net capital losses.
    - If Bob and Alice marry in 1997, only $3,000 of the combined $6,000 of capital losses could offset other 1997 income and generate a tax benefit (with the remaining $3,000 capital loss carried over to 1998).
    - However, if Bob and Alice wait and marry in 1998, all of the combined $6,000 of capital losses could be utilized on their 1997 individual returns, saving the couple combined taxes of over $1,000 in 1997, assuming a 36% tax rate ($3,000 × 36% = $1,080).

SOCIAL SECURITY BENEFITS

Taxpayers receiving Social Security benefits who are planning marriage must consider the taxability of those benefits if they are married. While the rules for taxing Social Security benefits are complicated, what is easily verified is that the rules favor individual taxpayers, not married taxpayers filing joint returns. The adjusted gross income base amounts at which Social Security benefits become taxable are as follows:

- For married taxpayers filing jointly, $32,000 ($44,000 for the 85% inclusion rules);
- For married taxpayers filing separately, $0 ($0 for the 85% inclusion rules); and
- For all other taxpayers (including individual filers), $25,000 ($34,000 for the 85% inclusion rules).

As we have seen with other income-based limitations, because the married filing jointly base level amount ($32,000) is less than twice the individual base amount ($50,000), married taxpayers receiving Social Security benefits risk having more of their benefits subject to tax than do two individual taxpayers combined.

PASSIVE ACTIVITY LOSSES

Generally, passive activity losses may not offset other income types (e.g., wages, interest, dividends, etc.) on an individual's return [§469]. However, a limited exception applies when the passive activity losses relate to rental real estate activities in which the taxpayer actively participates. For these passive activity losses, a taxpayer may offset up to $25,000 ($12,500 for spouses filing separate returns and not living together during the year) of such losses against other income types [§469(i)(3)]. The $25,000 offset is phased-out when a taxpayer's adjusted gross income exceeds:

- $100,000 for married filing jointly, individual and head of household filers; and
- $50,000 for married couples filing separate returns that do not live together during the year [§469(i)].

The $25,000 phase-out is complete for taxpayers with adjusted gross incomes of:

- $150,000 for married filing jointly, individual and head of household filers; and
- $75,000 for married couples filing separate returns that do not live together during the year [§469(i)(3)].

The passive activity loss limitation and phase-out should be considered when a couple is planning marriage.

Example 1-8:

- Bob and Alice are planning to marry on January 1, 1998.
- During 1997, Bob and Alice each had $20,000 of passive activity losses from rental real estate activities in which they actively participate.
- In addition, Bob's and Alice's 1997 adjusted gross incomes are $75,000 and $100,000, respectively.
    - If Bob and Alice marry on January 1, 1998, each may deduct their full $20,000 passive activity losses on their 1997 individual returns, because neither amount exceeds the $25,000 limitation and their individual adjusted gross incomes do not exceed $100,000.

Example 1-9:

- Assume the same facts as in Example 1-8, except that Bob and Alice marry on December 31, 1997 and file a joint return for 1997.

  - In determining Bob and Alice's deductible passive activity loss for 1997, initially, their combined $40,000 of losses is limited to $25,000. In addition, because the couple's combined adjusted gross income exceeds $100,000, the $25,000 limitation is subject to phase-out. In fact, because their combined adjusted gross income exceeds $150,000, all of the $25,000 limitation is phased out [§469(i)(3)].

  - Assuming a 31% marginal tax rate, marrying in 1997 instead of 1998 costs the couple $12,400 in combined taxes relating to their disallowed passive activity losses ($40,000 × 31% = $12,400).

HIGHER EDUCATION SAVINGS BONDS

A taxpayer who redeems certain savings bonds (Series EE bonds purchased after 1989) in a year when the taxpayer pays qualified higher education expenses (e.g., college tuition for the taxpayer or the taxpayer's spouse or dependent) may exclude from taxable income any bond redemption gain, not to exceed the qualifying education expenses amount [§135]. The income exclusion is phased out for taxpayers with 1997 adjusted gross incomes exceeding:

- $76,250 for married filing jointly taxpayers; and
- $50,850 for individual and head of household filers [§135(b)(2)].

The interest exclusion phase-out is complete for taxpayers with adjusted gross income of:

- $106,250 for married filing jointly taxpayers; and
- $65,850 for individual and head of household filers [§135(b)(2)(B)].

The interest exclusion is not available for married taxpayers filing separate returns.

Because the married filing jointly adjusted gross income limitation ($76,250) is less than the limitation for two individual taxpayers ($101,700), a couple filing as two individuals could potentially receive a greater tax benefit from this exclusion than would the couple filing a joint return.

SECTION 121 EXCLUSION — HOME SALES ON OR BEFORE MAY 6, 1997

Section 121 allows a taxpayer to exclude from income up to a $125,000 gain ($62,500 for married taxpayers filing separate returns) on the sale of his or her principal residence if:

- The taxpayer is at least 55 years old at the time of sale; and
- The taxpayer owned and used the residence as a principal residence for at least three of the preceding five years.

Section 121 provides that a taxpayer's marital status is determined as of the date the residence is sold. Section 121 is elective and can only be elected once in a taxpayer's lifetime. A married taxpayer's spouse must join in the §121 election whether or not the spouse has attained age 55. In addition, a taxpayer may not elect §121 treatment if he or she is married to an individual who has previously made such an election.

HOME SALES AFTER MAY 6, 1997

Because of recent law changes, §121 and its one-time exclusion of gain for taxpayers age 55 years and over are no longer applicable. Instead, a much more liberalized gain exclusion is in place for qualifying home sales occurring after May 6, 1997. Under the new rules, an individual taxpayer can exclude up to $250,000 of gain on the sale of a residence. To qualify, the taxpayer must have owned and occupied the home as a principal residence for at least two out of the last five years preceding the sale. As opposed to the one-time exclusion discussed above, the new exclusion applies to one sale every two years.

For married couples filing joint returns, the gain amount that is excluded increases to $500,000 if:

- either spouse meets the ownership requirements;
- both spouses satisfy the principal use requirements; and
- neither spouse is ineligible because of a home sale within the last two years.

If all three of these tests cannot be met, the couple may be eligible for the $250,000 exclusion if either of them meets the ownership and principal use requirements.

BUSINESS DEDUCTIONS

Many couples structure financial transactions with each other to ensure maximum tax benefits. For example, to gain a tax rate arbitrage, a taxpayer in a higher tax bracket may rent business property from a person in a lower tax bracket and deduct the expense. If the parties are married, the income and expense recognition wash and the spouse receiving the rent cannot deduct depreciation on the rental property [§267]. However, if the couple is not married, or not deemed to be married for tax purposes, income and expenses can be shifted among the parties through the rental process, with the party receiving rent income deducting depreciation on the rental property.

Example 1-10:

- Bob and Alice are thinking of getting married.
- Alice owns a building occupied by Bob's auto repair business.
- Bob pays Alice $1,200 per month in rent and Alice deducts annual depreciation on the property of $10,000.
  - If Bob and Alice marry, Bob's rental expense and Alice's rental income will wash on their joint return, but Alice's $10,000 annual depreciation deduction will no longer be allowed.
  - Therefore, Bob and Alice marrying would cost the couple $3,600 in increased taxes, assuming a 36% tax rate ($10,000 × 36% = $3,600).
  - Marrying would also prevent the couple from benefiting from any rate advantage if Bob's marginal tax rate is higher than Alice's.

Section 179 allows a taxpayer to expense up to $18,000 ($9,000 for married filing separately taxpayers) of tangible depreciable personal property placed in service during a year. If individuals planning marriage purchase significant depreciable business assets in a year that would qualify for §179 treatment, the couple might consider deferring the marriage to a later year to take advantage of two §179 limitation amounts.

ITEMIZED DEDUCTION LIMITATION

If a taxpayer forgoes the standard deduction and, instead, elects to itemize deductions, the itemized deduction amount may be limited. The limitation amount is the lesser of:

- The taxpayer's adjusted gross income, minus the "applicable amount," multiplied by 3%; or
- The taxpayer's itemized deductions multiplied by 80%.

For 1997, the "applicable amount" is $121,200 for married taxpayers filing jointly and unmarried taxpayers, and $60,600 for married couples filing separately. This limitation may also provide a tax incentive to postpone a marriage until after year-end, as is demonstrated in the next example.

Example 1-11:

- Bob and Alice, who have been living together for three years and have no children, have decided to marry on January 1, 1998.
- Bob and Alice each have adjusted gross incomes and itemized deductions of $200,000 and $30,000.
  - Each of the taxpayer's itemized deductions will be limited by $2,364 ($200,000 - $121,200 = $78,800 × 3% = $2,364).
  - If Bob and Alice had married one day earlier on December 31, 1997, and had elected to file a joint return for 1997, their joint itemized deduction of $60,000 would have been limited by $8,364 ($400,000 - $121,200 = $278,800 × 3% = $8,364).
  - Assuming a top marginal tax rate of 36%, postponing the marriage one day, from December 31, 1997 to January 1, 1998, saves the couple, because of the lessened itemized deduction limitation, a combined tax amount of over $1,300 ($8,364 - $4,728 = $3,636 × 36% = $1,309).

MEDICAL COSTS AND REIMBURSEMENTS

Medical costs claimed as itemized deductions on a taxpayer's return are also subject to a limitation based on the taxpayer's adjusted gross income (in this case, adjusted gross income multiplied by 7.5%). Therefore, as discussed above, the timing of a marriage might be accelerated or delayed if there is an imbalance of adjusted gross income and high medical expenses incurred by one or both individuals which could affect the total tax benefit from the medical expenses.

CASUALTY LOSSES

Individual taxpayers may deduct a loss on nonbusiness property resulting from a sudden, unexpected or unusual event. Such casualty loss may result from a:

- Fire;
- Storm;

- Shipwreck;
- Other casualty; or
- Theft [§165(c)(3)].

Each casualty loss amount is deductible to the extent of the following limitations:

- The casualty loss for the year must exceed 10% of the taxpayer's adjusted gross income; and
- Each casualty loss deduction must be reduced by $100.

Couples having significant casualty losses in a year, who are thinking of marriage, should consider whether to defer the marriage into the next year.

Example 1-12:

- Bob and Alice are contemplating a Christmas 1997 wedding and expect to file a joint 1997 return.
- Bob had some bad luck during 1997. In January, Bob's house was destroyed by fire, with Bob sustaining an unreimbursed loss of $30,000.
- In July, Bob's rebuilt house was burglarized and he sustained an unreimbursed loss of $10,000.
- For 1997, Bob and Alice expect their adjusted gross incomes to be $175,000 and $150,000, respectively.
    - If Bob and Alice marry during 1997 and file a joint return, their casualty loss deduction will be computed as follows:

Bob's unreimbursed fire loss	$30,000	
	(100)	$29,900
Bob's unreimbursed theft loss	10,000	
	(100)	9,900
		39,800
Adjusted gross income limitation [($175,000 + 150,000) × 10%]		(32,500)
Joint deductible casualty loss		$ 7,300

(continued)

Example 1-12 (Continued):

- However, if Bob and Alice postpone their marriage until 1998 and file as individual taxpayers in 1997, Bob's casualty loss deduction would be computed as follows:

Bob's unreimbursed fire loss	$30,000	
	(100)	$29,900
Bob's unreimbursed theft loss	10,000	
	(100)	9,900
		39,800
Adjusted gross income limitation ($175,000 × 10%)		(17,500)
Bob's deductible casualty loss		$22,300

- Assuming a 36% marginal tax rate, postponing the marriage until 1998 would save the couple combined taxes of $5,400 ($22,300 - $7,300 = $15,000 × 36% = $5,400) relating to the casualty loss.

INDIVIDUAL RETIREMENT ACCOUNT

A taxpayer may deduct annual contributions made to an individual retirement account ("IRA") if:

- The contribution amount is the lesser of $2,000 or the compensation amount includible in gross income; and
- Neither the taxpayer nor the spouse is an active participant in an employer-maintained retirement plan.

In addition, the maximum $2,000 IRA deduction amount is reduced for taxpayers who are active participants in qualified retirement plans and whose adjusted gross incomes exceed:

- $40,000 for married taxpayers filing joint returns ($0 for married taxpayers filing separate returns); and
- $25,000 for individual taxpayers (including heads of household).

(The $40,000 and $25,000 amounts are increased in tax years beginning after 1997. In 1998, they are $50,000 and $30,000, respectively.)

Therefore, for couples planning marriage, IRA deductions can be reduced or lost if the couple marries and one of the spouses is an active participant in an employer-maintained retirement plan and the couple's combined adjusted income exceeds $40,000.

Example 1-13:

- Bob and Alice are thinking of getting married.
- For 1996, Bob and Alice both have adjusted gross incomes of $25,000.
- Both Bob and Alice contributed $2,000 to their IRAs during 1996.
- However, Alice is an active participant in an employer-maintained retirement plan.
  - If Bob and Alice do not marry in 1996, Bob and Alice may each deduct the $2,000 contribution (even though Alice participates in her company plan).
  - However, if Bob and Alice marry, both Bob's and Alice's $2,000 contributions to their IRA accounts will be nondeductible because of Alice's active participation in her employer-maintained retirement plan, because their total AGI exceeds $40,000.

SPOUSAL IRA

Beginning in 1998, a non-working spouse is not considered an active participant in a qualified retirement plan merely because the individual's spouse is a participant. Thus, each spouse may fund his or her own IRA, even if one spouse is covered by a qualified retirement plan. The nonworking spouse's $2,000 maximum contribution begins to be phased out when adjusted gross income (AGI) exceeds $150,000 and is completely phased out when AGI reaches $160,000.

ROTH IRA

Beginning in 1998, Congress established a new type of nondeductible IRA, called a "Roth IRA." Generally, while contributions to a Roth IRA are nondeductible, the proceeds from the account (including contributions and earnings) can be withdrawn tax-free, provided the following conditions are met:

- Distributions begin at least five years after the year in which the IRA is established; **and**
- Distributions are made after the individual attains age 59½; **or**
- Distributions are to a beneficiary following the individual's death; **or**
- Distributions are attributable to the individual's being disabled; **or**

- Distributions are for the expenses of the individual's first-time home purchase.

Taxpayers with AGI of less than $100,000 may convert an existing IRA to a Roth IRA. Taxpayers must pay income taxes on the amount converted, but no 10% early withdrawal penalty will be imposed.

The maximum $2,000 contribution amount that may be contributed to a Roth IRA is coordinated with the individual's other retirement plan benefits and is reduced for single individuals with AGI between $95,000 and $100,000 and for married individuals with AGI between $150,000 and $160,000.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax ("AMT") system taxes alternative minimum taxable income ("AMTI") at the following rates:

- 26% for AMTI up to $175,000 ($87,500 for married filing separately taxpayers); and

- 28% for AMTI in excess of $175,000 ($87,500 for married filing separately taxpayers).

If a couple planning marriage has combined AMTI in excess of $175,000 that would generate an AMT liability, postponing the marriage and filing individually could potentially reduce the couple's total taxes.

In addition, for taxpayers having low levels of AMTI, §55(d) provides the following exemption amounts to reduce the potential AMT liability:

- $45,000 for married filing joint returns;

- $22,500 for married filing separate returns; and

- $33,750 for individuals and head of household filers.

Because the married filing jointly exemption amount ($45,000) is less than twice the individual and head of household exemption amounts ($67,500), there could be an AMT benefit for individuals to postpone marrying and file individual returns until the AMT benefit no longer applies.

EARNED INCOME CREDIT

Section 32 provides a refundable tax credit to certain low income taxpayers. For 1997, the "earned income credit" is available to a taxpayer who has:

- Earned income;

- Adjusted gross income below $25,760 for one child, $29,290 for two or more children, and $9,770 for no child; and

- Does not have more than $2,250 of "disqualified income" (income from taxable or exempt interest, dividends, and capital gains, and certain income from passive activities and nonbusiness rents or royalties).

The basic earned income credit for 1997 equals 7.65% of a taxpayer's earned income up to $4,340 if he or she has no children, 34% of earned income up to $6,500 if the taxpayer has one child and 40% of earned income up to $9,140 if a taxpayer has two or more children. The credit is phased out for taxpayers with earned income or adjusted gross income exceeding $5,430 for no children and $11,930 for one or more children. Using the 1997 credit percentages and phase-out levels, the earned income credit disappears at adjusted gross income levels above $9,770 for taxpayers with no children, $25,760 for taxpayers with one child and $29,290 for taxpayers with two or more children.

Married taxpayers may only claim an earned income credit if they file a joint return [§32(d)]. However, filing a joint return, while it would probably result in higher earned income, does not increase the adjusted gross income total phase-out amount. Therefore, for low income individuals contemplating marriage, it may be beneficial to defer the marriage until after year-end to maximize the earned income credit benefit.

CHILD TAX CREDIT

A taxpayer may claim a $400 tax credit in 1998 ($500 after 1998) for each child under the age of 17 as of the end of the year. The credit amount begins to be phased out for married taxpayers with AGIs of $110,000 ($75,000 for individuals and heads of household and $55,000 for married couples filing separately). As we've seen with other deductions and credits that are phased out at various income levels, the phase-out level for married filing jointly taxpayers is less than twice the phase-out amount for individual and head of household taxpayers. Therefore, delaying a marriage into the next tax year may be beneficial when the child tax credit phase-out amount on a joint return basis reduces the amount of credit that may be claimed on a combined individual or head of household basis.

PRENUPTIAL AGREEMENTS

Once a couple has decided to marry, certain tax planning is still possible in the form of a prenuptial agreement. In the current environment, when over one-half of all first marriages and more than 60% of all successive marriages will fail, more and more couples prefer a more thoughtful and organized treatment of their assets in the event of a divorce. Because many marriages are between individuals who have children from previous marriages, considerable wealth, or a successful business, these individuals want to avoid the dramatic and negative impact that an unplanned divorce can have on the division of marital assets. A prenuptial agreement can ease this impact.

USES OF PRENUPTIAL AGREEMENTS

Prenuptial agreements may:

- Help minimize legal costs;
- Allay family members' fears;
- Protect family assets;
- Protect closely held business assets;
- Protect assets from creditors;
- Clarify child custody and support; and
- Provide for the disposition of marital property.

Help Minimize Legal Costs. During a divorce, significant amounts of marital property can be lost because the parties need to pay substantial legal fees, appraisal fees and expert witnesses. Prenuptial agreements can be used to facilitate the divorce process by detailing and locking in the couple's wishes for marital property distributions.

Allay Family Members' Fears. Oftentimes, in second marriages, the children of previous marriages are concerned by the potential transfer of family wealth to the newly married spouse and his or her family in case of divorce or death. Because a prenuptial agreement is a legally binding contract and can be as lengthy and detailed as necessary, it can allay these concerns.

Protect Family Assets. Wealthier taxpayers may possess family assets and heirlooms that they desire to keep within family bloodlines and away from nonfamily members, such as a family member's spouse. A prenuptial agreement can be drafted so that such assets cannot be claimed as marital assets by the new spouse. However, most states do not allow one spouse to totally disinherit the other spouse. Under the states' probate laws, the surviving spouse, if disinherited, may usually elect against the will's provisions and receive a fixed percentage of the deceased spouse's assets.

Example 1-14:

- Bob and Alice, who may marry, have children from a prior marriage.
- Bob owns substantial family real estate that he would like to pass on to his children upon his death, with neither Alice nor her heirs receiving any interest in the real estate.
    - If Bob executes a will that leaves all of the real estate to his children, Alice could elect against the will and receive a fixed percentage of the real estate assets.

Example 1-15:

- Assume the same facts as in Example 1-14, except that Bob and Alice enter into a prenuptial agreement, in which Alice agrees to waive all claims against the real estate assets in exchange for a greater interest in Bob's separate assets and the couple's marital assets.
    - The prenuptial agreement should prevent Alice from electing against the provisions of Bob's will.

Protect Closely Held Business Assets. In situations where one of the marrying parties owns an interest in a closely held business, it is common for the owners to prevent a spouse from receiving voting rights or claims against the business. In this situation, the business owners should enter into an agreement that provides, in the event of the owners' marriage, that the parties will agree to execute a prenuptial agreement saying that the prospective spouse waives all rights in the closely held business in the event of the owner-spouse's death or divorce (however, see the above discussion regarding the disinherited spouse electing against the will). In addition, the business owners should consider entering into a buy-sell agreement in which each owner agrees to sell to the other owners upon each owner's death.

Protect Assets From Creditors. In some instances, one of the marrying spouses may have substantial debt and the other spouse would like to protect his or her assets. In a prenuptial agreement, the debtor spouse can agree to waive all claims against the other spouse's assets, except in the event of death or divorce.

Child Custody and Support. A prenuptial agreement can be used to clarify child custody and support for children from prior marriages or from the upcoming marriage. A prenuptial agreement can also be used to address custody issues. Section 152(e) grants a child's dependency deduction to the custodial parent, unless there is a separate agreement among the parties. Because the noncustodial parent generally provides a significant portion of the child's support, a prenuptial agreement can be used to have the custodial parent waive the right to the child's dependency deduction in the event of divorce.

Disposition of Marital Property. During the divorce process, substantial time and value can be wasted over the disposition of marital property. A prenuptial agreement can be used to designate ownership of marital property in the event of a separation, divorce or death in a thoughtful and organized manner.

TAX CONSEQUENCES

There are generally no immediate tax consequences from executing a prenuptial agreement. Tax concerns and considerations arise when the agreement is activated — that is, generally in case of death or divorce. Because a prenuptial agreement entails property transfers, the tax consequences of such transfers depend upon whether the transfers occur:

- Prior to the marriage;
- During the marriage; or
- After the marriage.

Property Transfers Prior to the Marriage. Generally, property transfers made between potential spouses prior to their marriage have negative gift and income tax consequences, as is demonstrated in the next example.

Example 1-16:

- Bob and Alice are considering marriage.
- Alice has substantial separate assets that she wants to protect in the event of her divorce or death.
- Therefore, Bob and Alice enter into a prenuptial agreement, and Alice agrees to transfer $500,000 of assets to Bob in exchange for Bob releasing all of his marital claims against Alice's separate property in the event of divorce or death.
- As a wedding present, on the day before the wedding, Alice transfers to Bob $500,000 of real estate pursuant to the prenuptial agreement. Alice purchased the land ten years ago and it has a $300,000 tax basis.

(continued)

Example 1-16 (Continued):

- Alice's transfer of the real estate to Bob prior to the wedding results in the following tax treatment:
  - Alice has a taxable gain for income tax purposes on the real estate transfer as if she sold the property for $500,000;
  - Alice has made a $500,000 taxable gift to Bob, subject to the gift tax rules (see the Chapter 7 discussion relating to gift taxes on marital property transfers); and
  - Bob has a $500,000 tax basis in the real estate received.

TAX PLANNING: WAIVING SURVIVING SPOUSE DEATH BENEFITS

Although there can be no pre-marriage spousal property transfers without negative tax consequences, a prenuptial agreement can require future spousal transfers. For example, under the Retirement Act of 1984, a surviving spouse has certain survivor right benefits under a qualified retirement plan. Although a spouse cannot waive these survivor rights in a prenuptial agreement (because the couple is not married and the waiver would constitute a property transfer), he or she may agree in the prenuptial agreement to execute the necessary consents to waive the survivor benefits after the marriage. This is an important point for second or later marriages.

Property Transfers During the Marriage. Generally, property transfers made between spouses while they are married result in no gift or income tax.

Example 1-17:

- Assume the same facts as in Example 1-16, except that Alice transfers the real estate to Bob the day after the wedding.
  - In this case, §1041(a) provides that there is no gain recognition for income tax purposes on property transfers between spouses (see the Chapter 6 discussion relating to §1041 property transfers).
  - In addition, for gift tax purposes, §2523(a) provides an unlimited marital deduction for gifts between spouses.
  - Therefore, no gift tax or income tax would be owed on the property transfer.

Property Transfers After the Marriage. If a marriage ends in a divorce, a prenuptial agreement often provides for the property and marital rights' transfers of both parties. As is discussed later, property transfers between spouses, even as a result of a prenuptial agreement, are classified as:

- Alimony (discussed in Chapter 3);
- Property settlements (discussed in Chapter 6); and/or
- Child support payments (discussed in Chapter 4).

While alimony is deductible by the paying spouse and taxable to the receiving spouse, neither property settlements nor child support payments are either deductible or taxable. Therefore, if specific treatment is desired in the spousal property transfer, the prenuptial agreement must be carefully drafted to bring about the desired results.

Agreement for Alimony Payments. As discussed in Chapter 3, for spousal transfers to be classified as alimony payments, the following requirements must be met:

- *Payments must be made in cash* — noncash spousal property transfers designated as alimony payments, even if made pursuant to a prenuptial agreement, are nondeductible. The prenuptial agreement should specify that all alimony payments must be made in cash;
- *Payments must be made under a divorce decree or a separate maintenance agreement* — for the alimony payments made under the terms of a prenuptial agreement to be deemed made pursuant to a divorce decree or a written separate maintenance agreement, the decree or written agreement must refer to the prenuptial agreement for payment determination;
- *Payments must end at the receiving spouse's death* — the prenuptial agreement must not be silent on this point. A formal statement should be included in the prenuptial agreement that the payor's obligation terminates upon the receiving spouse's death; and
- *Payments designated as property settlements or child support should be designated as such* — payments qualifying for alimony treatment, if not designated as property settlements or child support, will be treated as alimony payments. The prenuptial agreement should have a provision that allows the parties to change the spousal property transfers from alimony to property settlements or child support in future years. This will allow the parties some planning flexibility if tax considerations change [§71].

Agreement for Property Settlements. If a prenuptial agreement is used by marrying parties to establish each person's property and marital rights in the event of divorce, and they wish the marital property transfer to be free of income and gift taxes, then the prenuptial agreement should contain a provision that requires the property transfer to be included as part of the divorce decree. As briefly mentioned previously and more fully discussed in Chapter 6, marital property transfers made while the couple are married are free of income taxes [§1041] and gift taxes under the unlimited marital gift tax deduction [§2523].

Agreement for Child Support Payments. If a prenuptial agreement is used by marrying parties to qualify spousal property transfers as child support payments, as opposed to alimony, the amount constituting child support should be specifically stated in the agreement. In the event that an allocation between child support and alimony payments is not specifically made in the agreement, or subject to any condition relating to the child (e.g., one-half of payments cease when the child reaches the age of majority) all of the payments will be deemed alimony.

Example 1-18:

- Bob and Alice, intending to marry, enter into a prenuptial agreement in which on divorce, Alice will pay Bob $1,300 per month, terminating when Bob dies.
- Bob will have custody of the couple's son, Bill.
- The prenuptial agreement also provides that, as long as Alice continues to make the $1,300 per month payments, she will be relieved of all of her support obligations for Bill.
  - All of the $1,300 per month payment will be deemed alimony because it is impossible to determine from the agreement how much of each payment represents child support and how much represents alimony.
  - The result is the same even if Bob can show that all of the $1,300 per month went to support Bill.

SUMMARY

Whether a couple should marry is a question outside the realm of tax law. The tax effects of marrying and filing a joint return can easily be calculated. Although the answer has little or no impact on the couple's decision to marry, it does reveal the Code's negative treatment of married couples filing joint returns.

For the past several years, Congress has talked about doing away with the marriage penalty tax. Generally, the discussions have focused on adjusting the standard deduction and personal exemptions. As we discussed in this chapter, the marriage penalty tax comprises much more than these two items. The litany of items is so embedded in the Code (this chapter discusses 15 such items), it is unlikely that Congress will ever make all of the necessary changes to place married taxpayers filing joint returns on equal footing with individual return taxpayers. It is important that couples planning marriage compute their marriage penalty tax to determine its impact and determine whether its impact is sufficient to affect the date of the marriage.

A summary of the chapter's most important technical points follows.

- A taxpayer's marital status is determined on the last day of his or her taxable year. However, if the individual's spouse dies during the year, marital status is determined at the time of the spouse's death.

- A taxpayer's marital status will affect the taxpayer's filing status and, so, the tax bracket.

- The marriage penalty tax, with its variety of inequities, may provide tax incentives for some couples contemplating marriage to postpone the marriage into the following tax year.

- Because of deduction and credit income limitations and phase-outs, some couples planning marriage may receive greater tax benefits if they postpone their marriage into the next tax year and file as individual taxpayers in the current year. Benefits may derive from variations in:

  - Income tax rates;
  - Standard deductions;
  - Personal exemptions;
  - Capital losses;
  - Social Security benefits;
  - Passive activity losses;
  - Higher education savings bonds;
  - Section 121 exclusions;
  - Business deductions;
  - Itemized deductions;
  - Medical costs;
  - Casualty losses;
  - Individual retirement accounts;
  - Alternative minimum tax; and
  - The earned income credit.

- Prenuptial agreements are binding contracts between marrying couples that, in the event of divorce or death, can:
  - Help minimize legal costs;
  - Allay family members' fears;
  - Protect family assets;
  - Protect closely held business assets;
  - Protect assets from creditors;
  - Clarify child custody and support; and
  - Provide for the disposition of marital property.
- When properly structured, prenuptial agreements have no negative gift and income tax consequences.

CHAPTER 2

GENERAL TAX CONSEQUENCES OF TERMINATING A MARRIAGE

INTRODUCTION

In our continuing discussion of the life cycle of a marriage, we now turn our attention to the general tax consequences of ending a marriage. For purposes of our discussion, a marriage may be ended:

- By divorce;
- By legal separation; or
- Through death.

In general terms, a divorce is a legal action in which the marital parties seek to have the marriage dissolved under state law. The legal action results in a court judgment that:

- Dissolves the marriage;
- Distributes marital property; and
- Establishes spousal and child support.

Chapters 3 – 7 will discuss these divorce-related topics, while this chapter will focus on the tax consequences of a marriage ended by legal separation or the death of a spouse.

TAX CONSEQUENCES OF A LEGAL SEPARATION

The one area in the tax law most likely to cause confusion when terminating a marriage is legal separation. Almost everyone understands that when a couple divorces, the marriage is ended and each party files as an unmarried taxpayer (as either an individual or head of household). However, when a marriage is ended by legal separation before a final divorce decree, there may be uncertainty about the couple's filing status.

For married couples to file as unmarried individuals, the taxpayers must be legally separated. The courts have been inconsistent in recognizing different types of marriage dissolutions as legal separations qualifying couples for unmarried filing status. As we discussed in the last chapter, a taxpayer's filing status is important in computing tax liability. If the separated couple cannot agree to file a joint return, then the next best alternative is for the couple to file as unmarried individuals, because taxpayers filing as unmarried persons (e.g., individuals and heads of household) are taxed at a lower rate than married couples filing separate returns. Therefore, there is an incentive for separating couples not filing a joint return to qualify the marital dissolution as a "legal separation."

CREATING A LEGAL SEPARATION

Section 7703(a) provides that for a married couple to end their marriage and file as unmarried individuals, the couple must be legally separated under:

- A divorce decree; or
- A separate maintenance decree (a separate maintenance decree is a court action ordering one spouse to make support payments).

When making this "legally separated" determination, the courts look to state law and generally interpret the statutes strictly. For example, in states recognizing "limited divorces" as a means of creating legal separation, a separate maintenance decree will not be deemed sufficient to create a legal separation. This is true even though it would create a legal separation in another state that does not recognize limited divorces. (A limited divorce is a judicial separation in which a marriage is suspended and its duties and obligations are modified. In a limited divorce, the couple is ordered to live apart.) Therefore, if a court action is taken in a state to end a marriage and the spouses wish to file as individuals, it must be recognized in that state as an action that creates legal separation for tax return filing purposes.

The following court actions generally do not create a legal separation for tax return filing purposes:

- Interlocutory decrees;
- Orders for support *pendente lite*;
- Orders for support; and
- Voluntary separation agreements.

In states not recognizing limited divorces, the distinction between separate maintenance decrees and court orders for temporary support become important because the former creates a legal separation while the latter does not.

TEMPORARY SUPPORT AGREEMENTS AND OTHER COURT ACTIONS

When separating couples are under court orders that are not limited divorces or separate maintenance decrees, the court order must have the same effect as creating a legal separation to justify unmarried filing status. The court order must indicate a complete marital breakdown or a change in the marital relationship that makes rehabilitation impossible. For the most part, these court orders are seldom successful in establishing a legal separation and the success varies by the state.

Example 2-1:

- Darren and Samantha have been married for three years and live in Salem, Massachusetts.
- After various problems, Darren files for divorce and receives a court order restraining Samantha from entering the couple's home after retrieving her personal belongings.
- Darren files an individual return (as opposed to married filing separately) based on the court order indicating a complete breakdown of the couple's marriage.
- However, Massachusetts state law does not recognize such a court order as a legal separation.
    - Because the court order does not establish a legal separation for state law purposes, a legal separation is not established for tax return filing purposes and Darren and Samantha must file as married taxpayers (either jointly or separately).

Example 2-2:

- Darren and Samantha have been married for 18 months and have a stormy relationship. The couple live in Texas and have filed for divorce in the local court.
- The couple receives a court order requiring Darren to pay temporary child support for their infant daughter, Tabitha, as well as temporary spousal support.
- In addition, the court order prohibits either party from contacting the other without consent of the court and the other party. The court order also lists 26 prohibited actions, including the following:
    - Intentionally communicating with the other party by telephone or in writing in vulgar, profane, obscure or indecent language;
    - Threatening the other party by telephone or in writing or taking any action that is intended to annoy or alarm the other party; or

(continued)

Example 2-2 (Continued):

- Entering or remaining on the other party's premises without court authorization.

■ The court order is so specific and restrictive in its nature that it points to a total breakdown in Darren's and Samantha's marriage and, so, the court order establishes a legal separation under Texas law.

- Therefore, the couple may file as unmarried taxpayers [*Abrams v. Commissioner*, 57 TCM 1433 (1989)].

VOLUNTARY SEPARATION AGREEMENTS

Married couples who do not want formal separations and enter into voluntary separation agreements will have a difficult time qualifying for unmarried filing status. To qualify for unmarried filing status, the couple must structure the volunteer agreements in such a way that they convince the courts that the marital bond has been broken and the voluntary agreement represents a limited divorce or separate maintenance decree. However, in states requiring either limited divorce or separate maintenance decrees to justify a legal separation, it is unlikely the courts will accept voluntary separation agreements as establishing a legal separation.

TAX CONSEQUENCES OF THE DEATH OF A SPOUSE

For purposes of our discussion, the second way a marriage can end is through death. When a spouse dies, the surviving spouse and the decedent spouse's executor, administrator or personal representative must determine the couple's filing status for the year of death. We will use the term "executor" to refer to this person in the discussion that follows. Although filing a joint return generally results in the most favorable tax consequences, a number of factors and limitations must be considered before a final determination is made.

JOINT RETURN LIMITATIONS

Generally, the decedent spouse's final return is filed by the decedent's executor. So a surviving spouse who is not the decedent spouse's executor may not file a joint return with respect to the decedent spouse unless the executor agrees to the filing.

However, the surviving spouse may elect to file a joint return with the decedent spouse if:

■ No return has been filed with respect to the decedent spouse;

- No executor has been appointed before the joint return is filed; and
- No executor has been appointed before the joint return's filing date (including extensions) [Reg. §1.6013-1(d)(3)].

The surviving spouse may file a joint return with respect to the decedent spouse for all years in which a joint return is available and the above requirements are met. Generally, this will be for only one tax year. However, if the decedent spouse dies after the filing year, but before the return year's filing date, and the return has not been filed, then joint returns may be filed for two tax years.

Example 2-3:

- Darren and Samantha have been married for 15 years and live in New York State.
- On March 1, 1998, Samantha suddenly dies.
- Samantha has neglected to appoint an executor and one is not appointed until December 1, 1999.
- Darren and Samantha's 1997 return has not been filed prior to Samantha's death.
    - Darren may file a joint return with Samantha for both 1997 and 1998 because an executor is not appointed until after the 1998 return's extended filing dates.

Once the surviving spouse makes the joint return election, it is irrevocable following the return's filing date, unless the executor was appointed after the return's due date and does not agree to the joint filing.

If an executor is appointed before the return's filing date and filing the return (including extensions), the surviving spouse cannot unilaterally make the election to file a joint return with the decedent spouse. As mentioned above, when the executor has been timely appointed, a joint return can only be filed if agreed to by both the surviving spouse and the executor. However, if the surviving spouse mistakenly files a joint return with the decedent spouse without the executor's consent, and the joint return is not affirmed by the executor, the return is treated as the surviving spouse's married filing separately return, with the income and expenses allocated to each party.

Example 2-4:

- Assume the same facts as in Example 2-3, except that the executor of Samantha's estate is appointed September 1, 1999, before the filing of any 1998 returns.
- In addition, on September 15, 1999, Darren files a joint 1998 return for himself and Samantha without the executor's consent.
    - If the executor does not consent to the joint filing, Darren is deemed to have filed his 1998 return on a married filing separately basis, with his separate income and expenses being allocated to him.

If the surviving spouse properly files a joint return before an executor is appointed, the executor may disaffirm the joint return election by filing a separate decedent spouse return within one year of the original return's due date, including extensions [Reg. §1.6013-1(d)(5)].

Example 2-5:

- Darren and Samantha have been married for 25 years and live in Illinois.
- On December 30, 1997, Darren suddenly dies before he names his estate's executor.
- One year later, on December 15, 1998, Tabitha, Darren and Samantha's daughter, is finally named executrix.
- In the interim, on April 15, 1998, Samantha files a joint 1997 return with Darren.
- After being named executrix, Tabitha determines that a joint 1997 filing is not beneficial. Therefore, Tabitha prepares and files a separate 1997 return for Darren.
    - The return must be filed by September 15, 1999, one year following the original 1997 return's due date, including extensions.
    - Once Tabitha files Darren's separate 1997 return, the previously filed joint return becomes Samantha's separate return.

However, once a separate decedent spouse return is filed, the executor may change the election and file a joint return with the surviving spouse if:

- The election is made within three years of the original return's extended due date; and
- The surviving spouse agrees to the joint election [Reg. §6013(b)(1) and (2)].

Example 2-6:

- Assume the same facts as in Example 2-5, except that in reviewing her files before closing out Darren's estate, Tabitha finds an error in her workpapers calculating that a final 1997 separate return for Darren was beneficial.
- Tabitha contacts Samantha and, with her consent, refiles the final 1997 return on a married filing jointly basis.
    - Tabitha has until September 15, 2001 to file the amended joint return (three years from the original return's due date, including extensions).

FINAL JOINT RETURN BENEFITS

In Chapter 1, we discussed the benefits of joint return status in deciding when, or whether, to marry. These benefits discussed in Chapter 1 also apply to joint return status in the decedent spouse's final return year. In addition, several other items should be considered in deciding whether to file a final joint return.

Excess losses or credits. A final joint return should be considered if the decedent spouse has the following items in the year of death:

- Excess capital losses;
- Net operating losses;
- Suspended passive losses;
- Charitable contribution carryforwards; or
- Nonrefundable excess credits.

Because these items are only deductible or includible on the decedent spouse's final return and not on the decedent spouse's estate return, any potential benefit should be realized on a final joint return.

Example 2-7:

- Darren and Samantha are married and on July 15, 1997, Samantha sells 10,000 shares of Nosetweak, Inc. stock, realizing a $20,000 capital loss.
- In addition, earlier in the year, on April 12, Darren sold 5,000 shares of Endora, Inc. stock, realizing a $25,000 capital gain. These are the only capital gains and losses the couple generated during 1997.
- Samantha dies on October 31, 1997.
  - If Darren and Samantha file separate returns for 1997, Samantha's $20,000 excess capital loss will generate no tax benefit because the unused carryover amount cannot offset her future estate's taxable income.
  - Therefore, Samantha's executor should consider filing a final 1997 joint return with Darren, and offsetting the $20,000 capital loss against Darren's $25,000 capital gain.

Medical expenses. It is common for the decedent spouse to have medical expenses in the year of death. These deductions can be taken on the decedent spouse's final return or on the estate tax return. In addition, §213(c)(1) provides that any decedent spouse medical expenses paid out of his or her estate within one year of death are deemed to be paid when the expenses were incurred. Therefore, medical expenses paid in a subsequent tax year may be deductible on the decedent spouse's final return.

Example 2-8:

- Darren died on February 3, 1998 after a short illness.
- Due to a clerical error, a doctor bill incurred during Darren's final days is not submitted for payment to Darren's estate until January 15, 1999. The bill is paid on January 31.
  - The doctor's expense may be deducted on Darren's final 1998 return.

The decision whether to deduct medical expenses on a final joint or separate return or whether to claim the expenses on the decedent spouse's estate tax return requires a comparison of the incremental tax benefits generated. It may be beneficial to claim medical expenses on the decedent spouse's estate return because there is no 7.5% adjusted gross income limitation.

Example 2-9:

- Darren and Samantha had been married for 30 years when Samantha died on June 30, 1997.
- Samantha incurred $6,000 of medical expenses in her last days that were paid by her estate just after she died.
    - Based on these income levels, Darren and Samantha's 1997 joint incremental tax rate is 28%, Samantha's married filing separately 1997 incremental tax rate is also 28%, and Samantha's estate's 1997 incremental tax rate is 39.6%.
- The tax benefit of deducting the medical expenses on (1) Samantha's final separate return, (2) Darren and Samantha's final joint return, and (3) Samantha's estate return is calculated as follows:

  Samantha married filing separately tax benefit: $1,155 [$6,000 – ($25,000 × 7.5%) × 28%]

  Darren and Samantha joint return tax benefit: $105 [$6,000 – ($50,000 + $25,000 × 7.5%) × 28%]

  Samantha's estate takes the deduction: $2,376 [$6,000 × 39.6%]

    - Based on these facts, Samantha's estate should deduct the medical expenses on the estate tax return.
    - However, Darren and the executor of Samantha's estate may agree to split the medical expense deduction in any manner they wish.
    - If the expenses are deducted on an income tax return, the executor must attach a statement to the return stating that the estate waives the deduction on the estate tax return.

Partnership interests. Under Regulation §1.706-1(c)(3), partnership income or loss is deemed distributed as of the last day of the partnership's tax year, unless:

- A partner's death terminates the partnership; or
- A buy/sell agreement at a partner's death terminates the partnership.

It is unlikely under current law that a partnership's year-end will terminate on a partner's death. Therefore, unless the partner dies on the date of the partnership's year-end, the partnership's income or loss for the year will be reported by the decedent spouse's estate. If the partnership has taxable losses that could offset a surviving spouse's income on a final joint return, this benefit will be lost.

Example 2-10:

- Darren dies on December 30, 1997 owning a 10% interest in Tate Company, a partnership.
  - Darren's death does not terminate the partnership.
- Tate has a $3 million taxable loss for 1997, $300,000 of which will be reported on Darren's Schedule K-1.
  - The $300,000 loss is deemed to be distributed on December 31, 1997, one day after Darren's death, and must be reported on his estate tax return (Darren's final return will reflect "income in respect of a decedent" for the 1997 partnership loss amount relating to when Darren was alive).
- For a discussion of income in respect of a decedent, see the AICPA course, *Estate and Gift Taxation*.

One way to avoid this problem is for the partnership interest to be owned jointly by the married couple, with each spouse holding a right of survivorship.

DISADVANTAGES OF JOINT FINAL RETURNS

In the last chapter, we discussed the disadvantages of filing a joint return when thinking of marriage (the marriage penalty tax). These disadvantages also apply to joint return status in the decedent spouse's final return year.

The other primary disadvantage of filing a joint final return is the joint and several liability for both the decedent spouse's estate and the surviving spouse. Both parties become liable for any tax underpayment and interest if a joint final return is filed.

In addition to the joint and several liability issue, a joint final return should not be filed in the following instances:

- If it is likely that the surviving spouse or the decedent spouse's estate will become insolvent. Avoiding a joint final return filing will prohibit the solvent party from becoming liable for the insolvent party's taxes;

- If the surviving spouse is uncooperative or unable to assist in the joint return preparation;

- If the executor wants to close the decedent spouse's estate early and filing a joint return would delay the process. Because the decedent spouse's tax year ends on the date of death, a separate return could be filed immediately. However, if a joint return is filed with the surviving spouse, the executor must wait for the current tax year to end to include the surviving spouse's income; and

- If a joint return filing results in a marriage penalty.

ESTIMATED TAX PAYMENTS

Once the decedent spouse dies, future estimated tax payments may not be made on a joint basis [Reg. §1.6015(b)-1(c)]. However, if it is reasonable that the decedent and surviving spouses will file a joint final return, then the surviving spouse may base the separate estimated tax payments on the couple's joint income.

If the decedent spouse dies after joint estimated tax payments have been made, the surviving spouse, and not the decedent spouse's estate, has the responsibility for any remaining estimated tax payments.

SURVIVING SPOUSE

If the decedent spouse's executor elects to file a final separate return, the surviving spouse may still qualify for the beneficial joint tax rates. Section 2(a) says that a qualifying widow or widower may use the joint tax rates for two years following the decedent spouse's death if:

- The surviving spouse does not remarry;

- The surviving spouse maintains a household for more than one-half of the year for an unmarried son or daughter, adopted child, foster child or stepchild, as both the surviving spouse's and child's principal residence; and

- The surviving spouse would have qualified for joint return status if the decedent spouse had not died (i.e., the couple was married as of the decedent spouse's date of death, the couple had the same taxable year and neither individual was a nonresident alien at any time during the year).

Example 2-11:

- Darren and Samantha, who have been married for 12 years, have a ten-year-old daughter, Tabitha.

- Darren dies on September 1, 1997.

- Darren's executrix, Endora, elects to file Darren's final 1997 return on a married separate basis.

  - Assuming Samantha does not remarry and she continues to maintain a household for Tabitha, Samantha may file as a qualifying widow and use the beneficial joint tax rates for her 1997, 1998, and 1999 returns.

  - To receive this beneficial treatment, Samantha cannot file a return using married filing separate rates, and she must elect qualifying widow status.

SUMMARY

Marriages end because of divorce, legal separation or death. Divorces are discussed in Chapters 3 to 7, while in this chapter we discussed the tax consequences of marriages ending in legal separation or death.

Separated taxpayers trying to file as unmarried individuals face a great deal of uncertainty and discrimination in their filing status. If the state in which the couple resides does not provide for a limited divorce or a separate maintenance decree or if the couple decides to use a less confrontational form of separation, it is unlikely that the taxpayers will be deemed "legally separated" and able to file as unmarried individuals.

In states allowing limited divorces and separate maintenance decrees, these forms may be the only recognized standards for creating a legal separation. In these states, other forms of separation, including orders for support and voluntary separation agreements, generally do not create legal separation. Therefore, couples planning these types of separation must balance their benefits against the negative of not filing as unmarried individuals.

For marriages that end when one of the spouses dies, the decedent spouse's executor is responsible for filing the decedent's final return. However, if certain events occur, the decedent spouse's final return may be filed by the surviving spouse. Although a final joint return is generally beneficial, a number of factors and limitations must be considered before a final determination is made.

A summary of the chapter's most important technical points follow.

- For a married couple to end their marriage and file as unmarried individuals, the couple must be legally separated under a final divorce decree or a separate maintenance agreement;

- State law determines when a couple is legally separated. However, generally, to justify legal separation, the couple must secure a court order that indicates a complete marital breakdown or a change in the marital relationship that makes rehabilitation impossible;

- Voluntary separation agreements will not generally qualify a marital separation as a legal separation;

- Although a surviving spouse may file a joint final return with the decedent spouse in some circumstances, generally, the decedent spouse's executor is responsible for the final return filing;

- A joint final return should be considered if the decedent spouse has expenses, losses or credits that would not be deductible or includible on the decedent spouse's final separate return or estate return;

- A joint final return may not be beneficial because of the marriage penalty tax and joint and several liability; and

- A surviving spouse is eligible for the beneficial joint tax rates for two years following the decedent spouse's death, if:

    - The surviving spouse does not remarry;

    - The surviving spouse maintains a household for a qualifying child for more than one-half of the year; and

    - The surviving spouse would have qualified for joint return status if the decedent spouse had not died.

CHAPTER 3

ALIMONY PAYMENTS

INTRODUCTION

In the previous chapters, we discussed the tax consequences of marrying and ending a marriage through death, legal separation or divorce. The remaining chapters discuss the very specific tax consequences and considerations of terminating a marriage by divorce. The next five chapters will discuss the following divorce-related topics:

- *Chapter 3* — Alimony Payments;
- *Chapter 4* — Child Support Payments;
- *Chapter 5* — Child Dependency Issues;
- *Chapter 6* — Spousal Property Transfers; and
- *Chapter 7* — Planning for the Tax Impact of Terminating a Marriage.

In this chapter, we will introduce the concept of support payments in the context of a divorce or separation agreement. The two primary types of support payments are:

1. Alimony; and
2. Child support.

For purposes of our discussion, alimony refers to the support payments made by a taxpayer for the taxpayer's current or former spouse (alimony is also sometimes referred to as spousal support).

In most states, the spouse with higher income has a legal obligation to provide some measure of financial support to the other spouse at the time a divorce petition is filed (or when a legal separation begins). Support payments are usually determined at two times during the divorce process in the form of:

- Temporary support; and
- Final support.

It can take months or years for a divorce to be resolved and a final divorce decree to be issued, and the spouse with the lower income level may need financial support during the interim. Any support payments for the spouse and the children made between the date the divorce petition is filed and the date the divorce decree is issued are known as temporary support payments.

Alimony and child support payments that are made after a divorce becomes final are referred to as final support payments. Final support payments will typically be based on more complete and thoroughly examined financial information than temporary support payments.

TYPES OF ALIMONY

The following are the types of alimony payments that one spouse may make to the other spouse:

- Temporary alimony;
- Rehabilitative alimony;
- Permanent alimony;
- Term alimony; and
- Reimbursement alimony.

TEMPORARY ALIMONY

Temporary alimony is sometimes paid to the divorcing spouse with the lower income during the time period between when a divorce petition is filed (or legal separation begins) and when the final divorce decree is granted. The concept of temporary alimony is to allow the spouse with the lower income to maintain a standard of living, while the divorce is in process, that approximates the standard of living that was enjoyed during the marriage.

REHABILITATIVE ALIMONY

In many divorces, the spouse with the lower income will be encouraged to eventually become financially self-supporting. However, this can be difficult for a spouse who has been out of the workforce for some time or perhaps has never worked outside the home. Rehabilitative alimony may be given to such spouses to allow them to develop marketable skills that will result in financial self-sufficiency.

Example 3-1:

- Mark and Pam have been married for ten years and decide to divorce.
- Before their marriage, Mark and Pam both worked outside the home. However, after having children, Pam left the workforce and stayed home to raise the children.
- Following the divorce, Pam hopes to go to law school and practice law.
- In the separate maintenance agreement, Mark agrees to provide the following support payments:

  $2,000 per month for Pam and the couple's children ($1,400 of this amount is designated as child support payments); and

  $1,500 per month for three years to pay for Pam's law school expenses.

  - The $1,500 per month is rehabilitative alimony.

PERMANENT ALIMONY

Permanent alimony is paid by the spouse with the higher income to provide support for the spouse with the lower income some extended period of time following the final divorce decree. Typically, such payments will continue until the earlier of one of the following events:

- The spouse receiving the alimony remarries; or
- Either of the former spouses dies.

TERM ALIMONY

Instead of alimony payments being made for an open-ended period of time, some alimony payments will be made for a fixed time period, such as three years following the final divorce decree.

REIMBURSEMENT ALIMONY

The concept behind reimbursement alimony is that the superior earning power of the spouse with the higher income is a valuable asset that was developed by both partners during the marriage. For example, if the spouse with the higher income has an advanced degree, a state court may require the distribution of the value considered to be associated with that degree on the basis that during the period that one spouse was in school, the other spouse supported the student.

Example 3-2:

- Mark and Pam have been married for ten years and decide to divorce.
- During their marriage, Pam quit work and earned her MBA at a cost of $30,000. While Pam earned her MBA, Mark continued to work and support the family.
- In the separate maintenance agreement, Pam agrees to the following support payments:

  $1,500 per month for Mark and the couple's one child ($1,000 of this amount is designated as child support payments); and

  $30,000 one-time payment for the cost of Pam's MBA program.

  - The $30,000 one-time payment represents reimbursement alimony. (However, see the later discussion regarding alimony recapture for front-end loaded alimony payments.)

TAX TREATMENT OF ALIMONY

In general, payments classified as alimony for tax purposes are deductible by the spouse making the payments ("payor spouse") in the year they are paid and includible as taxable income by the spouse receiving the payments ("receiving spouse") in the year they are received.

For the payor spouse, the alimony payment is a deduction in computing adjusted gross income, rather than an itemized deduction. This is important because miscellaneous itemized deductions are subject to a 2% floor [§67] and itemized deductions in total are subject to phase-out for certain high income taxpayers [§68]. Furthermore, because the alimony deduction is not an itemized deduction, its payment reduces taxable income even if the payor spouse claims the standard deduction and does not itemize deductions. Alimony is also an allowable deduction in calculating alternative minimum taxable income [§56].

Under §71, with respect to divorce or separation instruments executed after December 31, 1984, any payment between spouses or former spouses will qualify as alimony or separate maintenance if *all* of the following tests are met:

- The payments must be made in cash;
- The payments must be made for, or on behalf of, a spouse or former spouse;
- The payments must be made pursuant to a divorce or separate maintenance agreement;
- The divorce or separate maintenance agreement must not designate non-alimony treatment;
- The divorced or legally separated spouses must not reside in the same household when payments are made;
- The payments must end when the receiving spouse dies;
- A joint return may not be filed for the year the payments are made; and
- The payments may not be considered child support.

PAYMENTS MADE IN CASH

Under the Temporary Regulations [Temp. Reg. §1.71-1T, Q&A 5], cash includes checks or money orders payable on demand. In-kind property may not be used by the payor spouse to qualify as alimony.

Example 3-3:

- In the separate maintenance agreement, Mark has agreed to pay Pam $1,500 a month of support payments until her death.
- Mark loses his job and has insufficient cash to make his support payments.
- In lieu of the cash payments Mark transfers $20,000 of real estate to Pam in satisfaction of his obligation.
    - Mark's payment of his support obligation with real estate does not qualify as an alimony support payment because it is not made in cash.

MADE TO, OR ON BEHALF OF, THE RECIPIENT SPOUSE

Cash payments to a third party on behalf of the receiving spouse are treated as alimony in certain situations, as discussed in the following:

- If a divorce or separate maintenance agreement requires cash payments to a third party, those payments will be treated as received by the third party on behalf of the receiving spouse. So, cash payments made to a third party on behalf of the receiving spouse of:

  - Rent;
  - Mortgage;
  - Taxes; or
  - Tuition liabilities

  will qualify as alimony or separate maintenance payments [Temp. Reg. §1.71-1T, Q&A 6 and 7].

- If the receiving spouse requests in writing that the payor spouse make a cash payment directly to a third party, instead of to the receiving spouse, as required by the divorce or separation instrument, such a payment will qualify as an alimony or a separate maintenance payment. The same is true if a cash payment to a third party is made without the request of the receiving spouse (or pursuant to a verbal request) and the receiving spouse consents to or ratifies the payment in writing. However, the written request, consent or ratification must; (1) state that the parties intend for the payment to be treated as an alimony or a separate maintenance payment to the receiving spouse and (2) be received by the payor spouse before the filing date of the tax return for the taxable year in which the payment is made.

- Cash payments made to maintain property owned by the payor spouse (including mortgage payments, real estate taxes and casualty insurance premiums), but used by the receiving spouse, are *not* considered payments made to a third party on behalf of the receiving spouse [Temp. Reg. §1.71-1T Q&A 6]. However, if each spouse has an ownership interest in the property, such payments could qualify as alimony or separate maintenance payments to the extent allocable to the receiving spouse's interest.

- Premiums paid by the payor spouse for either term or whole life insurance on the payor spouse's life, made under the terms of a divorce or separate maintenance agreement, will qualify as payments on behalf of the receiving spouse to the extent that the receiving spouse is the policy's owner. However, to the extent that the payor spouse is the policy's owner, such premiums will not qualify as alimony or separate maintenance payments.

PURSUANT TO A DIVORCE OR SEPARATE MAINTENANCE AGREEMENT

Payments will qualify as alimony if the payments are made pursuant to either:

- A divorce decree or a written instrument incident to such a decree;

- A separate maintenance decree (legal separation) or a written instrument incident to such a decree;

- A written separation agreement; or

- A decree for support not described above (e.g., a court order for temporary support pending the outcome of divorce or separation litigation or a court order for permanent support unrelated to the proceedings for divorce or legal separation).

Except in the last case, there is no requirement that the payments be for the receiving spouse's support or that they be described in the instrument as alimony or separate maintenance payments.

NOT DESIGNATED AS NON-ALIMONY PAYMENTS

The spouses may provide in the divorce or separate maintenance agreement that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor spouse and excludible from the receiving spouse's gross income [§71(b)(2)]. If the spouses have executed a separation agreement (as described in §71(b)(2)), any written agreement signed by both spouses which designates otherwise qualifying alimony or separate maintenance payments as nondeductible and excludible, and which refers to the separation agreement, will be enforceable.

A copy of the instrument which says the payments are not alimony or separate maintenance payments must be attached to the receiving spouse's Form 1040 for each year in which the designation applies.

SPOUSES MUST NOT LIVE IN THE SAME HOME

Generally, payments made when the payor and receiving spouses live in the same household *cannot* qualify as alimony or separate maintenance payments if the spouses are legally separated under a divorce or separate maintenance decree.

A home formerly shared by both spouses shall not be considered two separate households even if the spouses physically separate themselves within it. The spouses will not be treated as members of the same household if one spouse is preparing to leave the household of the other spouse, and leaves not more than one month after the date the payment is made. However, if the spouses are legally separated under a divorce or separate maintenance decree, a payment under a written separation agreement or a decree described in §71(b)(2)(C) (regarding decrees requiring a spouse to make support payments) may qualify as an alimony or separate maintenance payment whether or not the payor spouse and receiving spouse are members of the same household at the time the payments are made.

LIABILITY ENDS WHEN RECEIVING SPOUSE DIES

If the divorce instrument fails to include a statement that the payor spouse's liability to pay ends when the receiving spouse dies, then none of the payments, whether made before or after the receiving spouse's death, will qualify as alimony or separate maintenance payments.

Example 3-4:

- Pam is to pay Mark $10,000 in cash each year for a period of ten years under a divorce agreement which states that the payments will end when Mark dies.
- In addition, under the instrument, Pam is to pay Mark or Mark's estate $20,000 in cash each year for a period of ten years.
  - Because the $20,000 annual payments will continue after Mark's death, these payments will not qualify as alimony or separate maintenance payments.
  - However, the separate $10,000 annual payments will qualify as alimony or separate maintenance payments.

JOINT RETURN MUST NOT BE FILED

The couple must file separate returns [§71(e)] for the tax year in which the payments are made. Either or both of the spouses may qualify for head of household or individual filing status, depending on dependency qualifications (see Chapter 7 for a discussion of filing status following a divorce).

PAYMENTS MUST NOT BE CONSIDERED CHILD SUPPORT

We have seen that payment allocations between alimony and child support can have important tax consequences. A fixed child support payment is not includible in the receiving spouse's income and is not deductible by the payor spouse. A payment is fixed for child support if the divorce or separation instrument specifically designates a dollar amount as child support. A payment is also fixed for child support if it corresponds with a portion (e.g., a percentage of the payor spouse's income) that is designated in the divorce or separation instrument as child support.

Effective for agreements signed after December 31, 1984 (as well as for agreements signed before and modified after, if the modified agreement expressly states that these provisions are to apply), a payment is treated as being fixed for child support if it is reduced on the happening of a contingency relating to the payor spouse's child or at a time that can clearly be associated with such a contingency.

We will discuss child support payments more fully in Chapter 4.

ALIMONY RECAPTURE

If all of the alimony requirements discussed above are satisfied, then the payments will be included in the receiving spouse's gross income and will be deductible by the payor spouse in the year the payments are made. However, if the alimony payments are deemed "excessive," under §71(f), certain payment amounts may be "recaptured," as described below. The reason for the recapture rule is to limit a taxpayer's ability to characterize a property settlement as deductible alimony. (Property settlement payments are generally neither deductible by the payor spouse, nor taxable to the receiving spouse. Property settlements are discussed more fully in Chapter 6.)

For divorce or separation instruments executed after 1986 (the rules also apply to instruments executed before January 1, 1987, if the instrument is modified after that date and the modification expressly provides that the recapture rules are to apply), if the alimony payments decrease by more than a permitted amount in the first three years after separation, the payor spouse must include in gross income (i.e., recapture) "excess alimony" payments in the third post-separation year. The receiving spouse is permitted an equal deduction in computing adjusted gross income in the third post-separation year.

The term "excess alimony payment" is defined in §71(f) as the sum of the excess payments for the first post-separation year and the excess payments for the second post-separation year.

The first post-separation year is the first calendar year in which the payor spouse pays to the receiving spouse alimony or separate maintenance payments. The second and third post-separation years are the next two calendar years, respectively.

Example 3-5:

- Mark and Pam execute a separation agreement on December 31, 1997.
- Under the agreement, Pam is to make $3,000 per month payments to Mark beginning on December 31, 1997 and ending with a payment on January 15, 1999.
  - The three post-separation years are defined to be 1997, 1998 and 1999.
  - The first post-separation year is 1997, even though only one payment is made in that year.

Excess payments for the *first* post-separation year include the excess (if any) of the alimony amount paid in the first post-separation year over the sum of the average of the amount of alimony paid during the second post-separation year, less the excess payments for such year, and the amount of alimony paid during the third post-separation year, plus $15,000.

Excess payments for the *second* post-separation year are defined as the excess (if any) of the amount of alimony paid in the second post-separation year over the sum of $15,000, plus the amount of alimony paid in the third post-separation year.

The alimony recapture rules are actually simpler than the preceding discussion may suggest and are clarified by the following table and examples.

The following table calculates the amount of alimony required to be recaptured in the third post-separation year:

a. Payments in first post-separation year $_____
b. Payments in second post-separation year $_____
c. Payments in third post-separation year $_____

Recomputation Test One:

d. Enter amount from b. $_____
e. Enter c. + $15,000 $_____
f. Subtract e. from d. (not less than $0) $_____

Recomputation Test Two:

g. Enter b. $_____
h. Enter c. $_____
i. Add g. and h. $_____
j. Enter f. $_____
k. Subtract j. from i. (not less than $0) $_____
l. Divide k. by 2 $_____
m. Enter a. $_____
n. Enter l. + $15,000 $_____
o. Subtract n. from m. (not less than $0) $_____

Total Recapture

p. Add f. and o. $_____

Example 3-6:

- Assume the same facts as in Example 3-5 and further assume the following payments were made in the first, second and third post-separation years:

First post-separation year (1997)	$30,000
Second post-separation year (1998)	10,000
Third post-separation year (1999)	10,000

- Using the table above, the alimony recapture amount in 1998 is $5,000, computed as follows:

a. Payments in first post-separation year (1997)	$ 30,000
b. Payments in second post-separation year (1998)	$ 10,000
c. Payments in third post-separation year (1999)	$ 10,000

Recomputation Test One:

d. Enter amount from b.	$ 10,000
e. Enter c. + $15,000	$ 25,000
f. Subtract e. from d. (not less than $0)	$ 0

Recomputation Test Two:

g. Enter b.	$ 10,000
h. Enter c.	$ 10,000
i. Add g. and h.	$ 20,000
j. Enter f.	$ 0
k. Subtract j. from i. (not less than $0)	$ 20,000
l. Divide k. by 2	$ 10,000
m. Enter a.	$ 30,000
n. Enter l. + $15,000	$ 25,000
o. Subtract n. from m. (not less than $0)	$ 5,000

Total Recapture

p. Add f. and o.	$ 5,000

- Therefore, in 1999, Mark and Pam must recapture $5,000 of alimony in their separate returns. Pam must increase her taxable income and Mark must decrease his taxable income by $5,000.

TAX PLANNING

A transfer of cash intended to be treated as deductible/includible alimony can avoid the alimony recapture rules by varying the payments by no more than $15,000 each year during the first three post-separation years.

Example 3-7:

- In their 1997 divorce decree, Pam agrees to make support payments to Mark in the following amounts:

1997	$10,000
1998	50,000
1999	20,000
Total	$80,000

  - Using the alimony recapture steps, the cash payment amount subject to the alimony recapture rule is $15,000. If Pam and Mark rework the payment schedule in the following manner, so that the payments are more uniform (and none of the payment amounts vary by $15,000 in any given year), the alimony recapture rule would not apply:

1997	$25,000
1998	35,000
1999	20,000
Total	$80,000

ALIMONY RECAPTURE EXCEPTIONS

The following payments are exceptions to the alimony recapture rule:

- Payments received under temporary support orders [§71(b)(2)(C)];
- Payments made during the post-separation years to pay a fixed portion of the payor spouse's income from a business or property or from compensation for employment or self-employment; and

- Alimony or separate maintenance payments in any post-separation year cease by reason of the payor or receiving spouse's death or the receiving spouse's remarriage before the close of the computation year.

The Temporary Regulations [Temp. Reg. §1.71-1T Q&A 25] make it quite clear that the foregoing exceptions are the only alimony recapture exceptions. If alimony or separate maintenance payments decline or cease during a post-separation year for any reason other than one of these exceptions, such as:

- A modification of the divorce or separation instrument,
- A reduction in the support needs of the receiving spouse, or
- A reduction in the ability of the payor spouse to provide support,

then any excess payment amounts with respect to earlier post-separation years will be subject to recapture.

Example 3-8:

- Pursuant to a divorce decree, Mark is to make cash payments to Pam for $30,000 in each of calendar years 1996 through 2001.
- Mark makes $30,000 cash payments in 1996 and $10,000 in 1997, in which year Pam remarries and Mark's alimony payments cease.
  - The alimony recapture rule does not apply for 1997 or any subsequent year because of Pam's remarriage.

Example 3-9:

- Assume the same facts as in Example 3-8, except that the reason for Mark's $10,000 payment in 1997 is that Mark has financial problems.
  - Regardless of Mark's problems, the $30,000 payment in 1996 will be subject to recapture.

It is important to note that the alimony recapture rule does not only apply when the divorce instrument requires a reduction in payments. The rule can also apply when the payor spouse fails to make the payments required under the instrument, if the payments decline by more than the permitted amount. This can be true even if the failure to pay is permitted by a judicial modification of the original decree [Temp. Reg. §1.71-1T(d)]. Unfortunately, there is no provision in the regulations that would compensate payor spouses in the subsequent year when they make up the underpayment.

CARRYOVER OR CARRYBACK OF ALIMONY RECAPTURE DEDUCTION

Because of the bunching effect that the alimony recapture rule may produce, there is a distinct possibility that the receiving spouse's recapture deduction will exceed the current year's income. Section 71 does not provide any mechanism for carryback or carryover of this potential excess deduction amount. Because the alimony recapture deduction is a nonbusiness deduction, in calculating an individual's net operating loss, it may be taken into account only to the extent of the receiving spouse's nonbusiness income [§172(d)(4)]. Therefore, the alimony recapture deduction in excess of the receiving spouse's nonbusiness income cannot be utilized as a deduction in any year.

Example 3-10:

- In the separate maintenance agreement, Mark has agreed to make the following alimony support payments to Pam:

1997	$100,000
1998	20,000
1999	20,000

- The $100,000 payment in 1997 is made up of permanent alimony of $20,000 and reimbursement alimony of $80,000.
  - Using the alimony recapture table, $65,000 of the alimony paid in 1997 is excessive and must be recaptured in 1999. Pam will claim a $65,000 alimony recapture deduction on her 1999 tax return.
  - Assuming Pam's only other income for 1999 is her $20,000 alimony payment from Mark, Pam will have excess expenses on her return of $45,000. This excess amount does not result in a net operating loss that can be carried over or carried back.
  - Therefore, Pam will receive no tax benefit from the excess deduction.

SUMMARY

In this chapter, we discussed alimony support payments as a result of a divorce or separate maintenance agreement.

For alimony to be deductible by the payor spouse and taxable to the receiving spouse, the payments must meet certain requirements.

We also discussed alimony payments that are characterized as settlement payments and subject to recapture treatment, with the payor spouse recognizing income and the receiving spouse claiming an equal deduction amount.

A summary of the chapter's most important technical points follows.

- The following are the types of alimony payments that one spouse may make to the other spouse:
    - Temporary alimony;
    - Rehabilitative alimony;
    - Permanent alimony;
    - Term alimony; and
    - Reimbursement alimony.
- Alimony payments are generally deductible by the payor spouse and taxable to the receiving spouse.
- To qualify as alimony:
    - The payments must be made in cash;
    - The payments must be made for, or on behalf of, a spouse or former spouse;
    - The payments must be made under a divorce instrument;
    - The divorce instrument must not designate non-alimony treatment;
    - The divorced or legally separated spouses must not live in the same household when payments are made;
    - The payments must end when the receiving spouse dies;
    - A joint return may not be filed for the year the payments are made; and

- The payments must not be considered child support.

■ "Excessive" alimony payments made in the first three years following a divorce or separate maintenance agreement must be "recaptured," with the payor spouse recognizing alimony recapture income and the receiving spouse claiming an equal alimony recapture deduction.

CHAPTER 4

CHILD SUPPORT PAYMENTS

INTRODUCTION

General state law concepts require that parents must provide support for their children until they reach the age of majority. Generally, these payments are not deductible for tax return purposes because they represent personal expenses [§262].

In divorce or separation, the divorcing parties must determine the amount of child support each is to provide (either by agreement between the parties or by the court). Generally, if a child is living with one of the parents, the other parent is required to make payments to the parent having custody. These payments represent the "noncustodial" parent's (i.e., the parent not having custody of the child) contribution to the child's support.

CHILD SUPPORT PAYMENTS — TAX CLASSIFICATION

As discussed in Chapter 3, for payments to be classified as tax deductible alimony, one of the tests that must be satisfied is that the payments must not be classified as child support. Payments to support one's children are not deductible by the payor spouse and not taxable to the receiving spouse. However, if the divorce or separation document requires payments of taxable alimony and also provides for nontaxable child support payments, then the nontaxable child support amount must be paid completely before any part of the payment will be treated as taxable/deductible alimony (see later discussion) [§71(c)(3)].

Generally, for payments to be classified as child support, the divorce decree or separation document:

- Must fix (as an amount or a fraction of a payment) a sum which is payable for the support of a child;

- Must provide that an amount payable by the payor spouse to the receiving spouse will be reduced in the event of some contingency relating to a child (such as the child's marrying, dying, leaving school or reaching a designated age); or

- Must provide that an amount payable by the payor spouse to the receiving spouse will be reduced at a time which can clearly be associated with a contingency relating to a child.

FIXED PAYMENT AMOUNT

Section 71(c)(1) says that payments made to the receiving spouse are excluded from gross income for "any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse."

Section 71(c) specifies that a "fixed" amount does not have to be a specific dollar amount. Instead, a divorce agreement might "fix" as child support a variable amount that changes in relation to a benchmark, such as the payor spouse's income. The agreement could also provide that a portion of the total payment made by the payor spouse in excess of a specified amount represents the child support payment.

CHILDREN OF THE PAYOR SPOUSE

Section 71(c)(1) does not apply unless the child receiving the support is the child of the spouse making the payments. For example, if the child is the payor spouse's stepchild, then any amount payable to the stepchild's parents for support will not be covered by §71(c) and will be treated as alimony. This is true regardless of the amount specified as payable for the child's support.

Example 4-1:

- Joe and Molly divorce and as part of the divorce agreement Joe agrees to pay support for Jake, Molly's child from her first marriage. The agreement does not designate the payments as child support.

- Joe agrees to pay Molly $8,000 annually for Jake's support, until the first to occur:

  Jake's death;

  Molly's death; or

  Jake's 21st birthday.

  - Because Jake is not Joe's child, §71(c)(1) does not apply and the payments will be treated as alimony (assuming that the payments otherwise qualify as alimony), taxable to Molly and deductible by Joe.

Spousal payments may be treated as child support regardless of whether:

- The supported child is a minor;
- The supported child is obligated to be supported by either spouse; or
- The child lives with, or is actually supported by, either of the spouses [§71(c)(1)].

Example 4-2:

- Molly and Joe have one child, Jake.
- At the time of the couple's divorce, Jake is a 26-year-old CPA who has his own apartment.
- Molly requests child support because she wants to visit Jake occasionally. The agreement provides that Joe will pay Molly $3,500 per year for child support, until the first to occur of:

  Molly's death; or

  Joe's death.

  - Even though neither parent has an obligation to support Jake, §71 says that these payment amounts will be treated as child support.

REDUCTION ON CONTINGENCY RELATING TO A CHILD

If a payment that is specified in a divorce decree or separation agreement is reduced because of a contingency relating to the payor spouse's child, then the specified reduction amount is child support rather than alimony.

Temporary Regulation §1.71-1T (Q&A 17) provides that a contingency relates to the payor spouse's child when the reduction depends on an event, regardless of whether the event is likely to occur. Under the regulations, these contingency events include the following in which the child:

- Reaches a specified age or income level;
- Dies;
- Marries;

- Leaves school;
- Leaves the custodial spouse's home; or
- Becomes employed.

The intent of these rules is that "spousal support" (alimony) payments that are reduced because of some event occurring in a child's life really represent a disguised form of child support.

Example 4-3:

- Joe and Molly's separation agreement provides that Molly will pay Joe alimony of $3,000 per month until their son Jake's 21st birthday and $2,000 per month after that time.
- The contingent event relating to a child in this case is Jake's 21st birthday. The alimony reduction is $1,000 ($3,000 – $2,000).
  - Therefore, the $1,000 will be treated as child support, not deductible by Molly and not taxable to Joe.

Example 4-4:

- As part of their divorce decree, Joe agrees to pay Molly $1,000 a month until she dies.
- Molly has custody of their son Jake.
- The agreement states that when Jake reaches 16, the monthly payments will be reduced to $400.
  - Of the $1,000 payment, $400 is treated as alimony and the remaining $600 (the specified reduction) is treated as child support, not deductible by Joe and not taxable to Molly.

The fact that there are separate provisions in the divorce or separation agreement for alimony and child support does not prevent application of this contingency rule (Temp. Reg. §1.71-1T, Q&A 16).

Example 4-5:

- One paragraph of Joe and Molly's divorce agreement says that Molly must pay $100 per week for Joe's continuing support.
- In addition, a separate paragraph requires Molly to pay $50 per week for the support of Jake, the couple's minor child. The $50 support payment for Jake will end when Jake graduates from high school.
- In addition, the divorce agreement says that the $100 support payments to Joe will be reduced by $25 when Jake graduates from high school.
    - Under these circumstances, only $75 of the amount Molly pays to Joe for his support qualifies as alimony ($100 - $25).

ASSOCIATED WITH CONTINGENCY RELATING TO A CHILD

If a payment that is specified in a divorce decree or separation agreement is reduced at a time which can "clearly be associated" with a contingency that relates to a child, then the reduction amount is child support rather than alimony [§71(c)].

Unfortunately, §71(c) does not provide any indication as to how this "clearly associated" determination is made. However, the Temporary Regulations attempt to inject some measure of objectivity by providing that a reduction in payments will be treated as clearly associated under the following two rules:

1. The six-month rule; and

2. The multiple reduction rule.

Six-Month Rule. Support payments will be considered fixed, and so child support, if the payment reduction occurs not more than six months before, and not more than six months after, a child reaches ages 18, 21 or the age of majority under applicable state law. Such a reduction, if it occurs, is presumed to be clearly associated with a contingency relating to the child (Temp. Reg. §1.71-1T, Q&A 18).

For example, a separate maintenance agreement calls for spousal support of $1,000 per month until January 1, 1998, at which time it ceases. If the couple's child was born May 1, 1978, the child will be 20 years and 8 months old at the reduction date (when the spousal payments cease). Because this is within six months of the child turning 21 years old, the $1,000 is considered child support and, therefore, nondeductible by the payor spouse and nontaxable to the receiving spouse.

Example 4-6:

- Joe and Molly divorce.
- In the separate maintenance agreement, Molly agrees to pay Joe $5,000 per month, to terminate on November 1, 2010. None of the payment is designated as child support for the couple's son, Jake, who was born on March 1, 1992.
  - The $60,000 per year payment is treated as alimony because the November 1, 2010 payment termination is not within six months of Jake turning 18 years old.

Example 4-7:

- As part of Molly and Joe's divorce settlement, Molly agrees to pay Joe $2,500 a month until Joe dies.
- Joe has custody of the couple's child, Jake, who was born on October 20, 1984.
- The divorce agreement states that on January 1, 2003, Molly's required payment to Joe will decrease to $1,700 per month.
  - Because Jake will turn 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Jake's reaching 18 years old.
  - Therefore, the $800 a month ($2,500 - $1,700) reduction is treated as child support, regardless of the parties' intent.

Multiple Reduction Rule. Support payments will also be deemed fixed and, therefore, child support when the payments are to be reduced on two or more occasions, which occur not more than one year before or after a different child attains a certain age between the age of 18 and 24, inclusive. The measuring age must be the same for each child, but need not be a whole number of years.

Let's repeat this rule. A reduction is "clearly associated" with a contingency relating to a child (and so, child support) if:

- Payments are to be reduced on two or more occasions which occur not more than one year before or after; and

- A different child of the payor spouse attains a certain age between the age of 18 and 24, inclusive.

This provision appears to mean that if payments are to be reduced when a child is between 18 and 24 years old, the discrepancy in the ages at which payments are reduced must be at least more than two years if there are two children.

For example, assume X and Y have two children at the time of divorce. If payments from X to Y are reduced at a time when one child becomes 22 and again at a time when the other child becomes 24, payments associated with the reduction amount are treated as child support. However, if the reductions occur when one child is 21 years and 8 months and, again, when the other child is 23 years and 10 months, the reduction is not "clearly associated" with a contingency relating to a child.

Example 4-8:

- Joe and Molly are divorced on July 1, 1987.

- Their two children, Carl (born July 15, 1972) and Jake (born September 23, 1974), are 14 and 12, respectively, at the divorce date.

- Joe must pay Molly $2,000 in alimony per month.

- The divorce decree states that the alimony payments will be reduced by $500 on each of two dates, January 1, 1993 and January 1, 1997.

- On the first reduction date (January 1, 1993), Carl is age 20 years, 5 months, and Jake is age 18 years, 3 months. On the second reduction date (January 1, 1997) Carl is age 24 years, 5 months, and Jake is age 22 years, 3 months. The regulations prohibit reductions on occasions which occur not more than one year before or after Carl and Jake attain a certain age between 18 and 24, inclusive.

  - Therefore, the test works like this:

<u>First Reduction Date</u>

January 1, 1993

Carl's Age		Jake's Age	
20 yrs/5 mos		18 yrs/3 mos	
(1 year before)	(1 year after)	(1 year before)	(1 year after)
19 yrs/5 mos	21 yrs/5 mos	17 yrs/3 mos	19 yrs/3 mos

<u>Second Reduction Date</u>

January 1, 1997

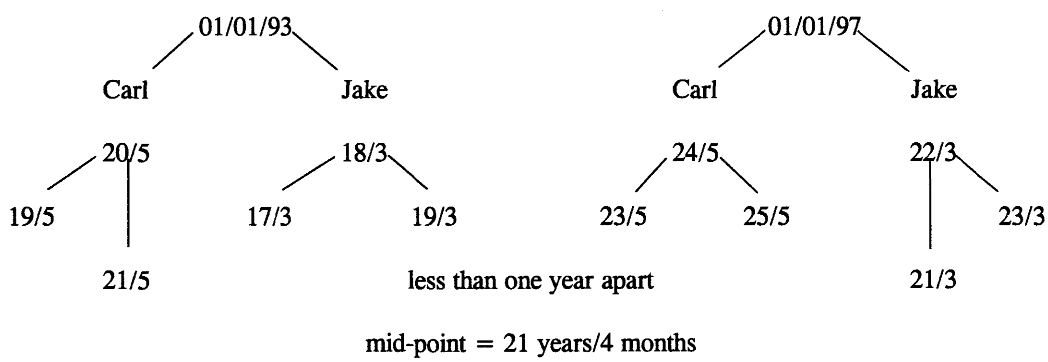
Carl's Age		Jake's Age	
24 yrs/5 mos		22 yrs/3 mos	
(1 year before)	(1 year after)	(1 year before)	(1 year after)
23 yrs/5 mos	25 yrs/5 mos	21 yrs/3 mos	23 yrs/3 mos

(continued)

Example 4-8 (Continued):

- Each occasion of a reduction occurs less than one year before or after a different child attains the age of 21 years, 4 months (the first reduction date occurs less than one year before Carl turns age 21 years, 5 months, and the second reduction date occurs less than one year after Jake turns 21 years, 3 months; thus, each reduction date occurs within one year from the date Carl and Jake reach age 21 years, 4 months).

  - By arranging the reduction date charts side-by-side, the "clearly associated" date becomes more apparent:



  - Age 21 years, 4 months is within one year of the age of both Carl and Jake at both reduction dates. Therefore, both of the reductions are presumed to be clearly associated with the children.

  - Payments under the divorce decree totaling the reduction amount ($1,000) do not qualify as alimony payments and are treated as nondeductible/nontaxable child support payments.

AVOIDING THE SIX-MONTH AND MULTIPLE REDUCTION RULES

Taxpayers who want payments to be treated as deductible alimony can engage in some planning to avoid application of the six-month and the multiple reduction rules that characterize payments as child support. Some possible ideas follow:

Provide for reduced payments on specified dates so that the reduction will not be viewed as involving a contingency relating to a child, or clearly associated with a contingency relating to a child.

Spouses can provide for support payments in the divorce agreement that end or decrease on particular dates, thus avoiding any of the child-related contingencies we have discussed above. For example, the dates that a child turns 18, 21 or the local age of majority are defined and, therefore, can be avoided.

If there is only one child for whom child support is intended, a maintenance clause can readily be drafted that disguises child support as alimony. For example, a reduction in payments that occurs at a time when an only child attains the age of 19 years and 6 months (assuming the age of majority is less than 19 years or more than 20 years) is presumed not to be clearly related to a contingency relating to a child and will be treated as alimony.

Example 4-9:

- Joe and Molly have one child, Jake, who was born on August 1, 1989.
- They live in Texas where the local age of majority is 18.
    - A provision in their separation agreement requiring an alimony reduction on any date other than between February 1, 2007 and January 1, 2008 (six months before and after Jake's 18th birthday) or between February 1, 2010 and January 1, 2011 (six months before and after Jake's 21st birthday) will not be treated as occurring on a date clearly associated with a contingency relating to Jake.

A risk with this tax planning concept is that a contingency relating to a child may happen before a scheduled reduction date. For example, assume that a child is eight years old at the time of the divorce and the scheduled reduction date is the child's 18th birthday. If the child were to die prematurely at age 12, the payor spouse could remain obligated under the agreement to continue making the support payments for another six years until the child would have turned 18 years old.

Example 4-10:

- As part of the separate maintenance agreement, Molly will provide $2,200 monthly child support for her son Jake until he graduates from a vocational training school.
- Jake is expected to complete his program in May 1998, the month of his 22nd birthday.
    - If the agreement provides for an alimony payment to Joe until Jake completes his training, the payments would be recharacterized as child support [i.e., because the cessation of payment would result from an event relating to Jake (graduation from vocational school)].

(continued)

Example 4-10 (Continued):

- Assume, however, that the agreement simply provides for payments of alimony until May 1998. This date is 12 months after Jake's 21st birthday.

  - Because that date is more than six months after Jake's 21st birthday, the termination date will not be deemed associated with a contingency relating to a child.

  - While this example avoids application of the six-month rule, it is not favorable to Molly because Molly will be obligated to continue the payments to Jake until May 1998, even if Jake drops out of vocational school or no longer requires any parental support.

It is much more difficult to draft a clause that disguises child support if there are two children, but such a clause is possible. If there are three or more children, drafting a clause that disguises child support as alimony becomes almost impossible. The only potential solution is to have all payments stop at one time.

Example 4-11:

- Joe and Molly have three children born on January 1 of 1973, 1975 and 1977.

  - If Joe and Molly structure Joe's payments to Molly, in conjunction with a divorce agreement, to terminate all at once on January 1, 1997 (when the oldest child becomes 24), the payments would not appear to constitute child support because no child is within six months of the age of 18 or 21 (their ages are 20, 22 and 24).

  - However, a payment termination when the oldest child is 23 would appear to constitute child support because it would occur when the middle child is 21. Also, a termination when the oldest child is 22 would appear to constitute child support because it would occur when the youngest child is 18.

Say in the divorce instrument that payments are to be renegotiated periodically, but always prior to a child-related contingency event, such as the child reaching legal age.

A divorcing couple may agree to have a divorce agreement requiring support payments that are not allocated between alimony and child support, and that contain no reduction provisions. In addition, the agreement can also say that the future payment amounts will be renegotiated upon the happening of specified events relating to the couple's child. In this situation, because no reduction amounts are specified in the divorce instrument, an amount of deemed child support cannot be determined. Therefore, this tax planning concept may yield favorable tax results because more of the payment amounts will be classified as alimony, at least until the first reduction actually occurs.

The risk with this tax planning concept is that the IRS may argue that prior payments were partially child support and deny deductibility in tax years still subject to audit. A more practical problem with this concept is that it requires periodic renegotiation between former spouses who may have difficulty in dealing with each other. Also, such renegotiations may require financial disclosures which one or both of the spouses may be reluctant to make.

Provide for an alimony reduction on an event in a child's life, but in an amount that cannot be calculated until the event occurs.

Example 4-12:

- In their divorce settlement agreement, Molly must pay $1,800 per month to Joe for support of the couple's son, Jake.
- The payments will terminate on the first to occur of:
  - Jake's death;
  - Jake's 21st birthday; or
  - Jake's college graduation.
- The agreement says that when the first event occurs, the alimony will be reduced by an amount equal to a percentage of Joe's household expenses.
  - In this case, the reduction cannot be determined until after the reduction event has occurred.
  - Therefore, it is arguable that the agreement does not provide for a payment reduction that is associated with a contingency relating to a child under §71(c)(2), and the payments are alimony.

REBUTTING THE CLEARLY ASSOCIATED PRESUMPTION

Even if a payment reduction is "clearly associated" with a contingency relating to a child, under either the six-month or multiple reduction rule, the presumption can nevertheless be rebutted by showing a different reason for the reduction, such as:

- Showing that the reduction was determined independent of an event relating to a child; or
- Establishing that there was also a complete elimination of alimony at the time of the payment reduction.

For example, the presumption that the payment reductions are child related can be refuted by showing that the reductions were related to some other event that did not relate to a contingency involving a child, such as the custodial spouse's completion of an educational program (e.g., completing a college degree program).

NONTAXABLE CHILD SUPPORT IS PAID FIRST

Section 71 also provides that if the divorce or separation document requires taxable alimony and also provides for payments of nontaxable child support, the nontaxable child support portion has to be paid in full before any part of the payment is treated as alimony. Therefore, if a divorce or separate maintenance agreement provides for both alimony and child support and if the payor spouse pays less than the total child support amount, the amount actually paid is not simply prorated between alimony and child support. Instead, the payment is treated as a child support payment in its entirety.

Example 4-13:

- In the couple's separate maintenance agreement, Joe is required to pay Molly $1,000 a month, $500 of which is designated as child support for the couple's minor child, Jake.
- During the current year, Joe paid Molly only $7,000, rather than the required $12,000.
  - Because the payment allocation is made first to child support, $6,000 ($500 × 12 months) is deemed child support payments and only $1,000 ($7,000 – $6,000) of the amount paid qualifies as alimony.

SUMMARY

In this chapter, we have reviewed some considerations regarding classifying payments as child support. The tax significance of this classification is that unlike alimony, child support is not deductible by the payor spouse and not includible in the receiving spouse's income. The theory behind this treatment is that unlike alimony (spousal support), the payor spouse has a legal obligation to support his or her children and payments for this support represent a personal obligation.

We discussed various circumstances necessary to avoid classifying payments as child support. We also reviewed some possible planning ideas.

Furthermore, we saw that if the divorce or separation document requires taxable alimony payments and also provides for nontaxable child support payments, then the nontaxable child support amount must be paid completely before any part of the payment will be deemed taxable alimony.

A summary of the chapter's most important technical points follows.

- Child support payments are nondeductible to the payor spouse and nontaxable to the receiving spouse;

- For support payments to be classified as child support, the divorce decree or separation document:

    - Must fix a sum which is payable for the support of a child;

    - Must provide that an amount payable will be reduced in the event of some contingency relating to a child; or

    - Must provide that an amount payable will be reduced at a time which can be clearly associated with a contingency relating to a child.

- The child receiving the support must be the payor spouse's child; and

- If a separate maintenance agreement provides for both alimony and child support payments and the payor spouse pays less than the total support, the amount paid is treated as child support in its entirety, to the extent the payment does not exceed the required child support, with any excess amount treated as alimony.

CHAPTER 5

CHILD DEPENDENCY AND CUSTODIAL ISSUES

INTRODUCTION

Child dependency and custody issues can have important tax consequences to divorcing couples. In this chapter, we will focus on various tax aspects of dependency status and custodial arrangements that should be considered by couples negotiating divorce and separate maintenance agreements.

We will begin our discussion with explaining why a child's dependency and custody may be important to each divorcing spouse. In addition, we will follow up this discussion by introducing some general concepts, followed by a detailed discussion of some special rules for determining which parent can claim the child as a dependent in typical divorce situations.

CHILD CUSTODY BENEFITS

The tax benefits of a taxpayer receiving custody of his or her child include the following:

- Claiming the child's exemption;
- Claiming the child tax credit;
- Qualifying for head of household filing status;
- Claiming the earned income credit;
- Claiming the child care credit; and
- Claiming the child's medical expense deductions.

THE DEPENDENCY EXEMPTION

One tax benefit of securing a child's custody in a settlement agreement is the dependency exemption. §151 permits taxpayers, for 1997, a $2,650 exemption amount (deduction) for each dependent meeting all of the following requirements:

- Either:
  - The dependent's gross income is less than $2,650 for the year; *or*

- The dependent is the taxpayer's child and is either:
  - Younger than 19 years old at year-end; or
  - A full-time student and younger than 24 years old at year-end.

- The taxpayer furnishes more than one-half of the dependent's total support for the year (there are exceptions for multiple support agreements and children of divorced parents; see the discussion later in this chapter);

- The dependent has a certain stipulated relationship to the taxpayer (most commonly, son or daughter, grandchild, stepchild, or adopted child);

- If married, the dependent does not file a joint return (except in limited circumstances); and

- The dependent is a U.S. citizen or a U.S., Canadian, or Mexican resident.

The dependency exemption deduction may be reduced or eliminated for certain high income taxpayers [§151(d)(3)], as discussed in Chapter 7.

CHILD TAX CREDIT

A second benefit of securing a child's custody in a settlement agreement is the child tax credit. A $400 tax credit ($500 in 1998 and after) may be claimed for each child under the age of 17 as of the end of the year. A child is eligible to be claimed if:

- the child can be claimed as a dependent; **and**

- the child is the taxpayer's son or daughter; **or**

- the child is the taxpayer's direct descendant, stepchild or foster child.

The credit amount begins to be phased out for married taxpayers with AGI of $110,000 ($75,000 for individuals and heads of households and $55,000 for married couples filing separately).

HEAD OF HOUSEHOLD FILING STATUS

A third benefit of a divorcing parent securing custody of his or her child in a settlement agreement is the single parent qualifying for head of household filing status. Under §2(b)(1), an unmarried taxpayer who maintains as his or her home a household which constitutes for more than one-half the year the principal place of residence for any unmarried child or stepchild (or any other person who is the taxpayer's dependent) qualifies for the favorable head of household tax rates. A married taxpayer who obtains a divorce or legal separation during the year (and who does not remarry) is considered to be an unmarried taxpayer at the end of the year and, thus, qualifies for head of household filing status. Chapter 1 discusses the qualifications and benefits of head of household filing status.

EARNED INCOME CREDIT

A fourth benefit of a divorcing parent securing custody of his or her child in a settlement agreement is the opportunity to claim the earned income credit if earned income (and adjusted gross income) is below $25,760 for one child or $29,290 for two or more children. (While an earned income credit may be claimed by someone without a qualifying child, an appreciably larger credit can be claimed by someone with one or more qualifying children.)

A qualifying child is a child who meets the following requirements:

- Is the taxpayer's son, daughter, adopted child, grandchild, stepchild or foster child;
- Was (at the end of the year):
    - Under age 19;
    - Under age 24 and a full-time student;
    - Any age but permanently and totally disabled; and
- Lived with the taxpayer in the U.S. for more than one-half of the year (the entire year in the case of a foster child).

See Chapter 1 for a discussion of the earned income credit.

CHILD CARE CREDIT

A fifth tax benefit of a spouse securing the custody of a child in a divorce is the taxpayer's ability to claim a child care credit. Section 21 allows a credit for child care expenses incurred for a child under the age of 13 and who qualifies as the taxpayer's dependent under §151(c). This credit is more fully discussed in Chapter 7.

DEPENDENT MEDICAL EXPENSE DEDUCTION

A sixth tax benefit of a divorcing parent securing his or her child's custody is the taxpayer's ability to claim medical expense deductions for the child's care. Section 213(a) permits taxpayers to deduct medical expenses paid for themselves, their spouse and their dependents, to the extent the expenses exceed 7.5% of the taxpayer's adjusted gross income.

Section 105(b) also allows taxpayers' to exclude from their gross income amounts paid to the taxpayer by the taxpayer's employer for medical expenses relating to the taxpayer, the taxpayer's spouse or the taxpayer's dependents. A child satisfying the §152(e) dependency tests is treated as a dependent for both the medical expense deduction and the income exclusion.

However, the regulations provide a special rule that if a child receives more than one-half of his or her support from parents who are either divorced or legally separated under a decree of divorce or separate maintenance agreement, the child is treated as *both* parents' dependent for purposes of the parents deducting the child's medical expenses.

Therefore, if a child's medical expenses are paid by the noncustodial parent who cannot claim the child as a dependent, that parent may still claim the medical expense deductions [Temp. Reg. §1.512-4T, Q&A 5].

In a situation where significant dependent child medical expenses are anticipated, the noncustodial parent should consider paying the expenses directly, rather than simply providing for the medical expenses as part of the child support payment. This would allow the noncustodial parent to claim a medical expense deduction even though he or she cannot claim a dependency exemption. If the medical expense payments are simply included with the child support payments, the noncustodial parent would be unable to claim medical expenses incurred on the dependent's behalf.

Running counter to this discussion is the custodial parent's viewpoint. This parent (assuming he or she itemizes deductions) may want to receive all of the spousal payments as nontaxable child support, pay the medical expenses and claim the medical expense deduction on his or her separate return.

These differing viewpoints illustrate that in spousal settlement negotiations, each spouse should consider:

- Their marginal tax brackets;
- Their ability to itemize deductions; and
- Whether claimed medical expenses will exceed their 7.5% adjusted gross income threshold.

CHILD DEPENDENCY SUPPORT ISSUES

In general, over one-half of a dependent's support must be provided by the parent claiming the dependency exemption. In Chapter 1, we noted that the support requirement for head of household dependency status and the exemption dependency status differ. Under §152, the payment of the following items constitutes support for the dependency exemption deduction:

- Food;
- Shelter;

- Clothing;
- Medical and dental care; and
- Education.

In addition, the courts and the IRS have considered the payment of the following items to constitute support payments:

- Toys;
- Birthday gifts;
- Christmas gifts;
- Summer camp expenses;
- Dance lessons; and
- Wedding receptions.

A child's total support generally includes income from all sources. Government benefits (e.g., Social Security benefits, welfare, food stamps, housing payments, foster care payments) are support items. However, in figuring whether the parent provided more than 50% of the dependent's support, they are not treated as provided by the parent. In addition, any amount provided by children toward their own support must be considered in determining whether a parent contributes more than one-half of the child's total support.

Example 5-1:

- Bill and Ann are divorced and Ann has custody of the couple's only child, Mark. Mark's support for the year totals $5,000.
- Ann provides $2,000 of this amount while Mark contributes the $3,000 balance.
    - Because Mark provides more than one-half of his own support, Ann may not claim Mark as her dependent.
    - However, in making the above support determination, if Mark is a full-time student at an educational institution for at least five months during the year, any scholarship received is not considered in computing Mark's support for the year.

Example 5-2:

- Assume the same facts as in Example 5-1, except that Mark does not make a direct contribution to his support. Instead, he receives a $3,000 scholarship from the college at which he is a full-time student.
    - Ann can claim Mark as a dependent because the scholarship funds are not considered in determining whether Ann provided more than one-half of Mark's total support for the year.

Another support issue is the value of support payments made during the year. In making this determination, courts have used a variety of valuation approaches, including the asset's:

- Fair rental value;
- Maintenance expense, plus depreciation effect; and
- Purchase price.

The valuation method currently favored by the IRS is the asset's purchase price.

Example 5-3:

- Bill and Ann are divorced.
- Ann provides their daughter, Katie, with food, clothing, medical care and lodging at a total cost of $6,000.
- Katie, using an inheritance, purchases an $8,000 automobile at the end of the year. The car could have been rented by Katie for $200 per month ($2,400 annually).
    - Katie is deemed to have contributed more to her own support than Ann. The car's annual lease value is not considered in determining Katie's support; only the car's purchase price is considered.
    - As a result, Katie is not Ann's dependent for the year.

IDENTIFYING THE SUPPORT PROVIDER AND ALLOCATING THE SUPPORT'S VALUE

Another practical support issue is identifying who provides the child's support. For example, divorcing parents are often equal owners of the residence housing the child. If neither parent has the right to the residence's exclusive occupancy, then each parent is deemed to contribute one-half of the residence's fair rental value to the child's support. On the contrary, if one parent has the right to the residence's exclusive use, then the other parent is not deemed to provide any portion of the residence's fair rental value to the child's support.

Allocating the value of support provided between a child and others who benefit is an unsettled area of the law. For example, when a child shares a residence with others, the allocation of rental value to the child's share is not entirely clear. Although one reasonable approach would be to divide the rental value equally among the occupants, courts have sometimes allocated a smaller portion to the child's share.

DEPENDENCY ISSUES INVOLVING A CHILD OF DIVORCED OR SEPARATED PARENTS

Having discussed the reasons that a child's dependency may be important to the divorcing spouses and the general rules for determining dependency, we now turn our attention to ways in which divorcing parents can claim their child as a dependent.

In general, the parent claiming the child's dependency exemption must substantiate that he or she provides more than one-half of the child's total support amount. Satisfying this substantiation requirement becomes difficult when parents are divorcing and perhaps unwilling to exchange information necessary to determine which of them is entitled to treat the child as a dependent.

The noncustodial parent is at a particular disadvantage. This parent is usually unable to determine the total amount spent on the child's support and, without this information, cannot substantiate that he or she provides more than one-half of the child's support.

SECTION 152(E)

Section 152(e) provides more certainty in determining which parent provides more than one-half of a child's support during a given year. Section 152(e) applies to parents who are:

- Divorced;
- Legally separated or separated under a written separation agreement; or
- Who live apart at all times during the last six months of the year.

Under 152(e), if two such parents together provide over one-half the child's support and together have custody of the child for more than one-half of the year, the parent who has custody the greater portion of the year may claim the dependency exemption.

Section 152(e) applies regardless of the support provided by each parent.

Example 5-4:

- Ann and her husband Bill separated in May.
- Their daughter, Katie, lived with Ann for the balance of the year. Ann and Katie's entire support was provided by Bill.
    - Because Ann and Bill together provided more than one-half of Katie's support and Katie lived with Ann longer than Bill during the year, Ann is deemed to have provided more than one-half of Katie's support and may claim the dependency exemption, despite the fact that she made no actual financial contribution to Katie's support.

In determining which parent has "custody" for the greater portion of a year, §152(e) looks to the divorce or separate maintenance decree. If no valid divorce agreement establishes custody or if the parents have joint physical custody, the parent having custody of the child for the greater portion of the year may claim custody for §152(e) purposes.

In these situations, the parent maintaining a diary showing every day of custody will have a clear advantage over the parent who does not maintain such a diary.

Exceptions to the General Rule. The following are exceptions to the general §152(e) rule that the custodial parent receives his or her child's dependency exemption:

- The dependency exemption can be claimed by the noncustodial parent if the custodial parent signs a written declaration that he or she will not claim the exemption and the noncustodial parent attaches the declaration to his or her tax return (IRS Form 8332);
- Section 152(e) does not apply if the exemption is awarded under §152(c), relating to multiple support agreements; or
- The dependency exemption can be claimed by the noncustodial parent if the divorce decree, separate maintenance agreement, or written separation agreement, was issued or executed before 1985 and:

- The instrument awards the dependency exemption to the noncustodial parent; and

- The noncustodial parent pays at least $600 for the child's support for the year.

Written Declarations Releasing the Exemption. A noncustodial parent can claim a child as a dependent by obtaining a written declaration from the custodial parent stating that he or she will not claim the child as a dependent. The exemption may be released for a single year, for a number of years, or for all future years, as specified in the declaration. IRS Form §332 can be used to make the declaration. The release must be attached by the noncustodial parent to the tax return on which the dependency deduction is claimed. If the release is for more than one year, the release must be attached to the noncustodial parent's return for each succeeding year as well.

It is difficult to know whether a dependency exemption release (if made at all) should be made on a permanent basis or on a year-by-year basis. As a practical matter, the custodial parent will probably want to release the exemption on a year-by-year basis. This will give this parent some "leverage" with the noncustodial parent to be sure that the separation agreement's other provisions are fully satisfied.

Example 5-5:

- Ann and Bill are divorced early in the year.

- Bill is the custodial parent of the couple's child, Katie.

- Ann provides substantial child support.

- The parties agree that, if Ann makes all child support payments as they become due, Bill will release Katie's dependency exemption to Ann.

- Suppose Bill executes a permanent dependency exemption release.

  - If he does so, Ann will claim the dependency exemption for all subsequent years, whether or not she pays a penny of child support.

- Instead, suppose that Bill executes releases on a year-by-year basis.

  - In this case, Bill is in a position to make certain Ann complies fully with the separation agreement by refusing to execute the annual releases.

The dilemma in this example might be solved by an arrangement under which Bill executes written releases for all years for which a dependency exemption is expected. The releases are then placed in the custody of a neutral party who agrees to deliver the releases to Ann annually upon receipt of proof that she has paid the designated child support amount and met the separation agreement's other provisions.

Although the matter is not free from doubt, §152(e)'s legislative history suggests that a long-term declaration releasing the dependency exemption is irrevocable. Unfortunately, it seems this would be the case even if the noncustodial spouse fails to perform according to the divorce agreement's other provisions.

Again, however, consider the situation from the standpoint of the noncustodial parent who is providing substantial child support. This spouse will want to ensure that he or she will obtain a written exemption release if he or she satisfies the divorce agreement's requirements.

However, a divorce or separation agreement provision that says that the noncustodial parent is entitled to the dependency exemption does not constitute a release for tax purposes. The custodial parent must execute a declaration that the noncustodial parent is entitled to the exemption.

Other Impacts of the Release. In regard to our previous discussion regarding head of household filing status, a custodial parent that assigns the dependency exemption to the noncustodial parent will not disqualify the custodial parent from head of household filing status. A child who is the dependent of either parent is always the custodial parent's dependent for head of household filing status even if the custodial parent has waived the dependency exemption.

We also saw that for purposes of medical insurance and medical expense deductions, a child is treated as both parents' dependent if the child is a qualifying §151 dependent [Sec. 213(d)(5)]. Therefore, signing IRS Form 8332 to release the dependency exemption does not prohibit the releasing spouse from claiming medical expense deductions paid on the dependent child's behalf. The same also applies for the child care credit.

Example 5-6:

- Bill and Ann are divorced, with Ann having custody of the couple's five-year-old daughter, Katie.
- Ann has released her right to claim Katie as a dependent to Bill under §152(e).
    - Katie is Ann's qualifying dependent for purposes of the §21 child care credit, even though Bill claims the dependency exemption for Katie under §151.

Stepparent Contributions. A stepparent filing a joint return with the custodial parent may not claim the child's dependency exemption if the custodial spouse has released the exemption to the noncustodial spouse, even if the stepparent provides more than one-half of the child's support. The reason for this rule is that the stepparent and the custodial parent are treated as one taxpaying unit and the contributions of one member of that unit may not obtain a benefit which the other unit member has agreed not to claim.

Multiple Support Agreements. Section 152(c) provides the second exception to §152(e)'s general rule that the custodial parent is entitled to the child's dependency exemption. Under a multiple support agreement, a noncustodial parent may claim the child's dependency exemption if all of the following requirements are met:

- No single person provides more than one-half of the child's support;
- Over one-half of the child's support is provided by persons, each of whom could claim the child as a dependent if they provided over one-half of the child's support;
- The noncustodial parent contributes more than 10% of the child's support; and
- Each person (other than the noncustodial parent claiming the exemption) who contributes more than 10% of the child's support files a written declaration that they will not claim the child as their dependent for that year.

Section 152(c) is important in such multiple support situations, because without it, no single individual could claim the child's dependency exemption.

Therefore, the dependency exemption can only be taken away under §152(c) if:

- Neither parent provides over one-half of the child's support; and
- A multiple support arrangement is entered into.

In all other cases involving divorced parents who together provide over one-half the child's support, the dependency exemption is awarded to the custodial parent under §152(e).

The dependency exemption claimed under a multiple support agreement is claimed on Form 2120 and must be filed with the taxpayer's return claiming the dependency exemption.

Example 5-7:

- During the year, Katie, who lives with her mother Ann, is supported by the combined contributions of her grandmother, Peggy, her other grandmother, Elizabeth, and her father, Bill.

- Peggy contributes 50%, Elizabeth 10% and Bill 40% to Katie's support.

- Ann, Peggy, Bill and Elizabeth enter into a multiple support agreement, under which Peggy, who provided one-half of Katie's support, signs Form 2120 assigning the dependency exemption to Bill and Bill files the form with his tax return.

    - Because all the requirements of §152(e) are satisfied, Katie is treated as Bill's dependent for the year. Elizabeth is not required to sign the form because she did not provide more than one-half of Katie's support.

Sections 152(c) and 152(e) may both apply in certain situations.

Example 5-8:

- Ann and Bill are the divorced parents of Katie. Each contributes 35% to Katie's support and Katie's grandmother, Peggy, contributes the remaining 30%.

    - In this case, both §152(c) and §152(e) could be applicable. If a multiple support agreement is executed, then §152(e)'s general rule is "overruled" by §152(c)'s special provisions.

    - However, in the event that no §152(c) multiple support agreement is executed, then §152(e) would apply and Katie would be considered the custodial parent's dependent.

In addition, when a child is claimed as a dependent pursuant to a multiple support agreement, the noncustodial parent is *not* entitled to any medical expense deductions for medical costs paid on the child's behalf.

Pre-1985 Agreements. A third situation in which the noncustodial parent can claim the dependency exemption involves pre-1985 divorce and separation agreements. This exception applies only if the divorce decree or separation agreement was in effect prior to January 1, 1985. Under rules applicable to instruments executed before this date, the noncustodial parent could claim the dependency exemption if the agreement provided that the noncustodial parent was entitled to the exemption and provided at least $600 of the child's support.

Example 5-9:

- Bill and Ann's divorce in 1982 provided that custody of their child Katie was given to Bill. It required Ann to pay Bill annual child support of $2,000 and provided that Ann was entitled to claim Katie's dependency exemption.

- Assume that in the current year, Ann did not pay any child support for Katie. However, she did buy $800 worth of clothing for Katie, while Bill contributed $6,000 towards Katie's support.

    - Under the special provision for "qualified pre-1985 instruments," Katie is treated as having received more than one-half of her support from Ann in the current year.

If a pre-1985 instrument does not specifically grant the dependency exemption to the noncustodial parent, the custodial parent receives the exemption regardless of the support amount provided by the noncustodial parent.

Negotiating an Agreement. We have seen that, generally, the custodial parent may claim his or her child as a dependent. We have also seen that the dependency exemption's value will vary, depending on such factors as the parents' marginal tax brackets. Assigning the dependency exemption should reflect such tax considerations.

For example, if the noncustodial parent's tax savings relating to the dependency exemption would be greater than the custodial parent's benefit, the custodial parent should release the right to claim the exemption to the noncustodial parent. However, the custodial parent may require the noncustodial parent to increase child support payments to compensate the custodial spouse for the exemption deduction loss.

Example 5-10:

- Bill and Ann are negotiating a separation agreement.
- Ann has taxable income of $85,000 per year and is in the 31% tax bracket, while Bill has taxable income of $20,000 per year and is in the 15% tax bracket.
- Bill will have custody of the couple's child, Katie, and Ann will pay child support.
  - If Ann has the right to take Katie's exemption, her tax savings attributable to the deduction would be $822 ($2,650 × 31%).
  - If Bill has the right to deduct the dependency exemption amount, his tax savings would be only $398 ($2,650 × 15%).
  - The former spouses' combined after-tax income would be maximized by Bill releasing the dependency exemption to Ann. However, in exchange for agreeing to do so, Bill should request additional support as compensation for the lost deduction.

In this example, the exemption phase-out provisions for high income taxpayers (discussed in Chapter 1) did not apply to either former spouse. However, if the phase-out applies, the exemption's value to one or both of the parents could be significantly reduced.

THE KIDDIE TAX

A child under the age of 14 whose investment income is greater than $1,300 is taxed at the parent's marginal tax rate. For a child of divorced parents, the child's custodial parent is the parent whose marginal tax rate is considered in determining the child's tax liability. This is also the parent obligated to file the child's return [§6012(b)].

In the case of married individuals filing separate returns, the marginal tax rate of the parent with the greater taxable income will apply in computing the under-14 child's tax liability.

If the custodial parent, who is responsible for filing the child's return, assumes the obligation to pay the child's taxes as well, and this obligation is substantial, provisions should be made in the divorce settlement agreement to compensate the custodial parent. It may be necessary to adjust child support payments or alimony to compensate the custodial parent for payment of the child's taxes. The tax consequences of child support versus alimony must be considered (as discussed in Chapters 2 and 3). In addition, accounting fees for return preparation should not be overlooked.

If parents are living apart and file separate returns, the parent who must prepare the child's return must obtain tax information from the other parent to determine which parent has the greater taxable income amount. In divorce or separation situations this may not be easy. Although such information can be obtained from the IRS, the child's return may not be timely filed.

Avenues designed to assist parents or guardians who have difficulty in obtaining the necessary information have been provided by the IRS. Form 8615, "Tax for Children Under Age 14 Who Have Investment Income of More Than $1,300," should be completed using reasonable estimates of the parent's income or filing status or the children's net investment income. The appropriate lines should be marked "estimated" and, when the correct information is obtained, an amended return should be filed to report and pay additional tax or to claim a refund. No penalties will be assessed if reasonable estimates are used. However, interest will accrue as usual on any overpayments or underpayments [Ann. 88-70, I6502].

ELECTION TO INCLUDE CHILD'S INCOME

A parent may elect to include on his or her return the unearned income of a child under the age of 14 whose income is more than $650 and less than $6,500 and consists solely of interest and/or dividends. The child is treated as having no gross income and does not have to file a tax return if the election is made. The election is made using Form 8814 and is not available if estimated tax payments have been made in the child's name or if the child is subject to backup withholding.

If a parent makes such an election to include the child's unearned income in his or her return, the amount included consists of:

- The child's gross income greater than $1,300; and
- The lesser of:
  - $97.50; or
  - 15% of the child's income exceeding $650.

Parents Who Qualify to Make the Election. To qualify in making the election, parents must file Form 1040 or Form 1040NR and fall within one of the following categories:

- The parents file a joint return;
- If the parents file married filing separately, only the parent having the greater taxable income may make the election; or
- If the parents are separated under a divorce or separate maintenance agreement, only the custodial parent may make the election. If the custodial parent remarries, he or she may make the election

on a joint return with the new spouse. However, if the custodial parent and the new spouse do not file a joint return, the custodial parent can make the election only if he or she has higher taxable income than the new spouse.

Deductions the Parent May Not Take. If a parent elects to report the child's income on his or her return, the following deductions that the child would have been entitled to claim on his or her own return may not be claimed by the electing parent:

- The child's standard deduction;
- Penalty on early withdrawal of the child's savings; and
- The child's itemized deductions, such as the child's investment expenses or charitable contributions.

To compute whether it is beneficial to include a child's income on his or her parent's return, first compute the child's tax as if the child files a separate return. Next, compute the parent's incremental tax of including the child's income on the return. Then, compare both calculations to determine which results in the lower tax.

SUMMARY

In this chapter, we first reviewed some of the economic consequences of dependency status. This began with a discussion of the exemption deduction. We also discussed the definition of a dependent and some of the general requirements for qualifying an individual as a dependent.

We then considered dependency issues for children of divorced or separated parents. For example, if the divorced or separated spouses together provide over one-half of a child's support, and together have custody of the child for more than one-half of the year, one parent will generally be entitled to the exemption. The question becomes which of the two parents receives the exemption.

A summary of the chapter's most important technical points follows.

- The tax benefits of a taxpayer receiving custody of his or her child include the following:
  - Claiming the child's dependency exemption;
  - Claiming the child tax credit;
  - Qualifying for head of household filing status;
  - Claiming the earned income credit;
  - Claiming the child care credit; and

- Claiming the child's medical care expense deductions.

■ In general, over one-half of a dependent's support must be provided by the parent claiming the dependency exemption;

■ Under §152(e)'s general rule, if two divorced or legally separated parents together provide over one-half of a child's support and together have custody of the child for more than one-half of the year, the parent who has custody for the greater portion of the year may claim the dependency exemption;

■ In exception to §152(e), the noncustodial parent may claim his or her child's dependency exemption if:

  - The custodial parent signs a written declaration that he or she will not claim the child's exemption;

  - The noncustodial parent is awarded the exemption under a multiple support agreement; or

  - The noncustodial parent was awarded the exemption under a pre-1985 divorce agreement and contributes at least $600 for the child's support for the year.

■ A child under the age of 14 whose investment income is greater than $1,300 is taxed at his or her parent's marginal tax rate. For a child of divorced parents, the child's custodial parent is the parent whose marginal tax rate is considered in determining the child's tax liability; and

■ A parent may elect to include on his or her return the unearned income of a child under the age of 14 whose income is more than $500 and less than $5,000 and consists solely of interest and/or dividends.

CHAPTER 6

SPOUSAL PROPERTY TRANSFERS

INTRODUCTION

State law generally provides that husbands and wives have interests in property acquired during their marriage, no matter which spouse holds the property's title. On divorce or separation, these property rights may be satisfied by property divisions and cash and other property transfers, either by mutual agreement or pursuant to a court decree.

The spousal property or cash transfers are usually made directly to the spouse but, in some cases, the transfers may be made:

- To another individual;
- To a trust; or
- To another entity.

In determining whether a property distribution represents a fair payment for the release of a spouse's marital rights, the current and future tax consequences of the transfer must be closely analyzed.

As we discussed in previous chapters, cash property distributions made pursuant to a divorce or separation agreement are nontaxable to the receiving spouse and nondeductible by the payor spouse, unless the payments qualify as alimony.

Section 1041 applies to all spousal property transfers not classified as alimony or child support payments.

SECTION 1041

Section 1041 generally provides that neither the transferor spouse nor the transferee spouse recognizes any gain or loss on marital property transfers. Section 1041 applies to transfers between both married spouses and former spouses, if the transfers to the former spouse are made pursuant to a divorce or separate maintenance agreement.

Example 6-1:

- Bill owns 100 shares of Alpha stock in which he has a $400,000 tax basis. The stock's fair market value is $600,000.
- Bill's wife, Denise, owns no property. The couple live in a jurisdiction that provides for the equal division of marital property.
- According to their settlement agreement, Bill transfers 50 Alpha shares to Denise in exchange for the release of her marital property rights.
    - Under §1041, neither Bill nor Denise will recognize any gain on the property transfer.

Example 6-2:

- Assume the same facts as in Example 6-1, except that Bill and Denise are not seeking a divorce.
    - The property transfer from Bill to Denise results in no gain recognition.
    - Section 1041 applies to transfers between both former spouses (if made pursuant to a divorce or separation decree) and current spouses.

Section 1041 applies only to gains and losses and not to ordinary income transactions. So, for example, when a spouse who has not reported any interest on Series EE bonds transfers the bonds to the other spouse, the transferor spouse must recognize the accrued interest up to the transfer date [Rev. Rul. 87-112, 1987-2 CB 207].

TRANSFERS DURING MARRIAGE

Section 1041 applies to any spousal property transfer regardless of whether the transfer is:

- A gift; or
- A sale or exchange between spouses acting at arm's length.

This includes both transfers made in exchange for the relinquishment of property or marital rights, or some other nontaxable exchange. For §1041 to apply, divorce or legal separation need not be contemplated between the spouses at the time of the transfer, nor must a divorce or legal separation ever occur.

Example 6-3:

- Bill and Denise are married and file a joint return.
- Bill is the sole owner of a condominium unit.
  - A sale or gift of the condominium from Bill to Denise is a §1041 transfer.

Example 6-4:

- Bill and Denise are married and file separate returns.
- Bill is the owner of an independent sole proprietorship, X Company.
- In the ordinary course of business, X Company makes a sale of property to Denise.
  - This sale is a §1041 transfer of property between spouses.

However, in appropriate circumstances, general tax principles, including the step transaction doctrine, may be applicable in recharacterizing an apparent §1041 transaction into another type of taxable or nontaxable transaction.

TRANSFERS IN CONNECTION WITH A DIVORCE OR SEPARATION

Section 1041 applies to the transfer of property between former spouses only if the transfer is "incident to a divorce" [§1041(a)(2)]. As defined under §1041(a), a transfer is incident to a divorce if it:

- Occurs within one year after the date on which the marriage ceases; or
- Is "related" to the marriage's cessation.

With respect to this second provision, the temporary regulations provide guidance as to when a transfer is "related to the cessation of the marriage." Specifically, under Regulation §1.1041-1(T)(Q&A 7), a property transfer is related to a marriage's cessation if the following two conditions are satisfied:

- The transfer is made pursuant to a divorce or separation instrument as defined in §71(b); and

- The transfer occurs within six years from the date on which the marriage ceases.

Both of the above conditions must be satisfied for the transfer to be related to a marriage's cessation. If a transfer satisfies only one of the above conditions, it is presumed to be unrelated to a marriage's cessation.

This presumption that a transfer is unrelated to a marriage's cessation may be rebutted by showing that the transfer was made to divide property owned by the former spouses. For example, the presumption may be rebutted by showing that:

- The transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer, such as legal or business impediments to transfer or disputes concerning the property's value owned at the marriage's termination; *and*

- The transfer was made promptly after the impediment to transfer was removed.

Two Private Letter Rulings illustrate this provision's application. In Private Letter Ruling 9123053, a wife had a one-half interest in her husband's business. In accordance with the divorce agreement, the husband was required to pay a stated sum to the wife in several installments in exchange for her one-half interest. Some of the payments were made more than six years after the end of the marriage. The IRS concluded that the cash payments were not alimony because they were payable even after the wife's death and that §1041 applied because the payments were property transfers in connection with the couple's divorce. The IRS concluded that the payments were made to divide property owned at the time of the divorce, even though some payments were made more than six years after the divorce.

In Private Letter Ruling 9235026, a transfer of a business occurring more than six years after the end of a marriage was held to be incident to divorce. The delay was caused by a dispute over the purchase price and payment terms, which resulted in litigation. After the dispute was resolved, the transfer was made promptly. The IRS concluded that the transfer qualified for §1041 nonrecognition treatment.

Example 6-5:

- Denise has acquired a valuable stamp collection. In connection with her divorce, she must transfer one-half of the collection's value to her husband, Bill.
- Bill and Denise retain their own appraisers to value the collection, but the appraisers cannot agree on a value because of the collection's unique nature.
- Finally, two years later, additional appraisals are completed and a value is agreed upon.
- However, a legal problem arises in connection with the stamp collection's legal title and it takes an additional four years to resolve this issue.
- Finally, more than six years after their divorce, but immediately after the title problem is rectified, stamps are transferred to Bill.
    - In this case, assuming the parties can substantiate that the distribution delay was due to legal and valuation issues, and that the transfer was made immediately after all such impediments were removed, §1041's nonrecognition provisions should apply.

Under §1041, property transfers include both cash and non-cash transfers. However, many cash transfers between former spouses will fall within the definition of alimony or child support, as we discussed in Chapters 3 and 4.

However, if a cash transfer does not qualify as alimony or child support, then §1041 will generally govern the transfer's taxability.

TRANSFEREE SPOUSE'S TAX BASIS IN THE PROPERTY RECEIVED

Section 1041 transfers are treated as gifts for tax purposes. Section 1041(b) provides that the transferor spouse's basis in the property transferred carries over and becomes the transferee spouse's basis. This rule differs in one important respect from the general gift tax basis rules. For gift purposes, the donee's basis in property received, for purposes of calculating a loss on the property's subsequent sale or exchange, is the lesser of the transferor's basis or the property's fair market value at the time of the gift [§1015]. However, for §1041 purposes, the transferee spouse's basis is the same as that of the transferor spouse's basis in calculating either gain or loss.

Example 6-6:

- Denise owns 200 shares of ABC Corporation stock with a tax basis of $10,000.
- Pursuant to their divorce, Denise gives her husband, Bill, the 200 shares at a time when the stock's fair market value is $8,000.
  - Under §1041, Bill's basis in the shares is $10,000, Denise's carryover basis. Bill's subsequent sale of the shares for $8,000 results in a $2,000 recognized loss.
  - However, if Bill had received the stock by gift and not pursuant to a §1041 transaction, his stock basis under §1015 would have been $8,000, resulting in no gain or loss on the sale.

TRANSFEREE SPOUSE'S HOLDING PERIOD IN THE PROPERTY RECEIVED

Because the transferor spouse's basis of property received in a §1041 transfer carries over to the transferee spouse under §1223(2), the transferee spouse's holding period in the property received includes the transferor spouse's holding period. Put another way, §1223 provides that the transferee spouse will "tack on" the transferor spouse's holding period. This is important primarily when it results in long-term capital gain treatment, which is only available when the property sold has been held for more than one year.

Example 6-7:

- In connection with their divorce, Bill transfers to Denise some gold coins that he purchased 15 months ago. The coins have a value of $10,000 and Bill paid $8,500.
  - Bill's holding period for these coins carries over to Denise under §1223(2).
  - If Denise immediately sells these coins for $10,000, she will be entitled to long-term capital gain treatment on the $1,500 gain.

TAX PLANNING: AVOIDING §1041 TREATMENT

There will be occasions when it may be beneficial to avoid §1041's mandatory nonrecognition provisions. This is demonstrated by the following two examples:

Example 6-8:

- Bill and Denise are divorcing under amicable terms. The couple owns some real estate which has a $20,000 tax basis and a $100,000 value.
- The property will be transferred to Bill in connection with the divorce.
- Bill has started a new business and expects to be in a much higher tax bracket in future years.
  - Consequently, he may want the property transfer to fall outside §1041 and recognize the gain currently, when he is in a lower tax bracket.

Example 6-9:

- Assume the same facts as in Example 6-8, except that the couple's basis in the property is $150,000.
  - If the property is investment property or property held for sale and it is transferred in a §1041 transaction, no loss may be claimed on the transfer, because §1041 applies to the deferral of both gains and losses.
  - To have the transfers fall outside of §1041, Denise and Bill can transfer the property more than one year after the divorce in an arm's-length transaction clearly unrelated to the divorce settlement.

LIABILITIES ASSUMED ON THE PROPERTY TRANSFER

Section 1041 also applies to property transfers when the transferee spouse assumes or takes the property subject to liabilities. In addition, §1041 applies even if the transferred property is subject to liabilities in excess of the transferor spouse's basis [Temp. Reg. §1.1041-1T, Q&A 12].

Example 6-10:

- Denise owns property having a fair market value of $10,000 and an adjusted basis of $1,000.
- In contemplation of making a transfer of this property incident to a divorce, Denise borrows $5,000 from a bank, using the property as security for the borrowing.
- Denise transfers the property to Bill who takes the property subject to the $5,000 liability.
    - Under §1041, Denise recognizes no gain or loss on the property transfer and Bill's adjusted basis in the property is $1,000.

While §1041's nonrecognition provisions apply when the property transferred is subject to liabilities in excess of the property's basis, this rule has been amended so that it no longer applies to transfers made in trust. For transfers made in trust, §1041(e) provides that the transferor spouse must recognize a gain equal to the excess of the liability assumed over the basis amount. In addition, the trust's basis in the property is increased by the recognized gain.

In the preceding example, if the transfer was made in trust, Denise would have recognized a $4,000 gain on the property transfer ($5,000 in liabilities assumed less the $1,000 tax basis) and the trust's basis in the property would have been increased to $5,000 (the $1,000 carryover basis plus the $4,000 gain recognized).

TRANSFERS TO A THIRD PARTY ON BEHALF OF A SPOUSE

We have seen that for §1041 application, a property transfer must be to a spouse or former spouse. However, in certain circumstances, transfers directly to a third party on behalf of a spouse or former spouse will qualify for §1041 treatment. Temporary Regulation §1.1041-1T, Q&A 9 provides the following examples:

- When the third-party transfer is required by a divorce or separation instrument;
- When the third party transfer is pursuant to the spouse's (or former spouse's) written request; or

- When the spouse (or former spouse) ratifies the transfer to the third party on his or her behalf. Such ratification must:
  - State that the parties intend the transfer to be treated as a §1041 transfer; and
  - Be received by the transferor spouse prior to filing the tax return for the year in which the transfer is made.

In the three situations described above, the property transfer is treated as made directly to the transferee spouse (or former spouse) immediately followed by the transferee spouse transferring the property to the third party. The deemed transfer from the transferee spouse (or former spouse) to the third party is not a §1041 transaction that qualifies for nonrecognition treatment.

Example 6-11:

- To satisfy his obligations under a divorce decree, Bill transfers to Denise 100 shares of stock having an aggregate fair market value of $10,000 and a $3,000 basis.
- Denise asks Bill to transfer the stock to her CPA to compensate her for services.
  - As a result of this transfer, Denise recognizes a $7,000 gain (for the difference between the stock's $10,000 value and Bill's $3,000 carryover basis). That is, Denise is treated as if she received the stock, with a $3,000 carryover tax basis, and sold the stock for $10,000, giving the proceeds to her CPA.
  - However, Bill will be fully protected from gain recognition under §1041.

TRANSFERS TO AND FROM A CONTROLLED ENTITY

While transfers *to* a controlled entity (other than a trust, in limited circumstances) can qualify for §1041 treatment, §1041 does not apply to transfers to a spouse *from* a controlled entity, even one that is wholly owned or controlled by the other spouse. Consequently, a property sale by a corporation controlled by one spouse to the other spouse is not a §1041 transaction.

Example 6-12:

- Denise is a stamp dealer who owns stamps in her own name and in the name of her wholly owned corporation. She and her husband, Bill, have agreed that she will sell Bill $150,000 worth of stamps for $150,000.

- If the agreement requires a direct transfer of the stamps from Denise to Bill, §1041 will apply to the sale.

  - However, if the agreement requires a transfer of the stamps from Denise's corporation to Bill and a transfer of cash from Bill to the corporation, §1041 will *not* apply. Instead, the corporation will recognize a gain or loss on the stamp sale to Bill and Bill will have a stepped-up cost basis in the stamps he acquires.

The example above illustrates that if (1) an individual wants to avoid §1041 application in a sale to a spouse and (2) the property to be transferred is owned by a controlled corporation, then the transfer should be made by the corporation rather than by the individual.

TRANSFERS OF SERVICES

Section 1041 applies to the transfer of any property (tangible or intangible), whether or not the property is owned or acquired during the marriage. However, §1041 does not apply to the marital transfer of services.

RECORDKEEPING REQUIREMENTS

Temporary Regulation §1.1041-1T Q&A 14 provides that the transferor spouse must, at the time of the transfer, supply the transferee spouse with records sufficient for the transferee spouse to determine the property's basis and holding period. In addition, in the case of a property transfer with potential investment credit recapture, the transferor spouse must, at the time of the transfer, supply the transferee spouse with records sufficient for the transferee spouse to determine the recapture amount and period of such potential liability. The Temporary Regulations are silent regarding information with respect to potential depreciation recapture, although it is clear that this potential liability carries over to the transferee spouse.

VALUATION ISSUES

Section 1041 transactions present some difficult valuation problems. Because of the carryover basis rules, the transferee spouse acquiring marital assets with a low tax basis should consider the ultimate tax liability he or she has assumed because of the built-in appreciation on the acquired property. Valuing this potential tax liability is extremely difficult, and both spouses should be aware of it in settlement negotiations.

Property having a considerable built-in gain should be recognized as having a reduced value when received as part of a divorce or separation agreement. If the transferor spouse makes no such concession, the transferee spouse should request a substitution of either cash or property that has a value equal to or less than its basis. However, assuming there is no choice in the matter, then the settlement agreement should provide additional compensation for any built-in gain amount.

Example 6-13:

- Denise owns 100 shares of ABC Corporation stock having a $200,000 fair market value and a tax basis of $100,000.
    - If the shares are distributed to Denise's former husband Bill as part of a divorce, the shares' value to Bill is less than $200,000, depending on how long Bill intends to hold the shares and trigger the $100,000 ($200,000 - $100,000) built-in gain.

Example 6-14:

- Bill owns property having a fair market value of $100,000 and an adjusted basis of $10,000.
- In contemplation of transferring the property to his spouse, Denise, incident to a divorce, Bill borrows $40,000 from a third party, secures the debt with the property, and Bill retains the $40,000 debt proceeds.
- Bill transfers the property, subject to the liability, to Denise.
    - Bill's transfer to Denise results in no gain recognition to either Bill or Denise and Denise's adjusted basis in the property is $10,000.
    - If Denise later sells the property for $100,000, she will have $60,000 left after paying the $40,000 debt, but will also owe tax on the $90,000 gain ($100,000 - $10,000).

Generally, there is no obvious answer to valuing the tax relating to a built-in gain on property transferred because:

- The transferred assets may be retained by the transferee spouse for an extended period of time;
- The transferee spouse's ultimate tax rate on the built-in gain is unknown at the transfer date; and
- The transferee spouse may keep the assets until death, at which time any unrealized built-in gain could escape taxation.

Despite these problems, some estimate of the present value of future tax costs must be made so that the transferee spouse receiving the low basis assets is not seriously disadvantaged. Some of the factors used in making this valuation should include:

- Whether the asset is likely to be disposed of in a taxable or tax-free transaction;
- When the disposition is likely to occur;
- What the transferee spouse's marginal tax rate will be at the time of disposition; and
- What discount rate should be employed in calculating the future tax liability's present value.

COMMON SPOUSAL PROPERTY TRANSFERS

We now turn our attention to particular types of property transfers that may occur in connection with a divorce or separate maintenance agreement. The specific property transfers we will discuss include the following:

- Principal residence;
- Individual retirement accounts;
- Life insurance policies; and
- Installment notes.

PRINCIPAL RESIDENCE

Perhaps the most common and important marital asset is the divorcing spouses' principal residence. The following Code Sections must be considered in determining the tax consequences of transferring the couple's principal residence:

- §1041;
- §1034; and
- §121.

For home sales occurring after May 6, 1997, §1234 has been repealed and §121 has been substantially modified, as previously discussed.

Because we have discussed §1041's provisions in the previous sections, we will not repeat them in detail here. However, in general, if one spouse transfers an interest in the couple's principal residence to the other spouse, §1041 protects both the transferor and transferee spouses from recognizing any gain.

Section 1034. For home sales on or before May 6, 1997, §1034 provides that if a taxpayer realizes a gain on the sale of his or her personal residence, the gain is deferred [§1034(a)]:

- If the taxpayer purchases a new principal residence for a price at least equaling the old residence's adjusted selling price; and
- If the new principal residence is purchased within a four-year "window" period. This window period begins two years before and ends two years after, the first residence's sale date.

If the replacement residence's purchase price is less than the old residence's adjusted selling price, the taxpayer must recognize a gain for the difference [§1034(a)]. Section 1034(e) provides that the taxpayer's new residence basis is reduced by any deferred gain amount.

Section 1034 applies only to the deferral of gains, not losses. Consequently, if a taxpayer sells his or her principal residence at a loss, the loss is a nondeductible personal loss.

Because §1034 applies only to a taxpayer's principal residence, which is generally the one in which he or she lives, if a taxpayer owns more than one residence, only the principal residence is eligible for §1034 treatment.

One of the problems for home sales arising in connection with divorce is the issue of "principal residence." When one spouse moves out, but continues to own the residence (jointly or alone), a later sale may not qualify for deferral because the home is no longer that spouse's principal residence. For example, a husband and wife who jointly own a home divorce. Pursuant to the terms of the divorce, the wife lives in the home until their child graduates from high school. When the home is sold, the wife can defer her portion of the gain since the home continues to be her principal residence; the husband cannot defer his portion of the gain because he no longer lives there.

Section 1034 in Divorces. Section 1034 becomes particularly important in divorce or separate maintenance agreements when the principal residence is not transferred from one spouse to the other, but, instead, is sold to a third party.

Generally, for §1034 to apply, both the old and new residences must be owned and used as a principal residence by the same taxpayer. Therefore, when either the old or new residence is owned by one person, but occupied by another, §1034 is generally not applicable. However, §1034(g) provides that a married couple can elect to, essentially, be treated as one person to satisfy these same taxpayer ownership requirements.

Therefore, in divorce situations, former spouses can qualify for gain recognition deferral regardless of which spouse actually owns the old and new residences. To make the §1034(g) election, the spouses must file a consent in which the parties agree to have the basis of their replacement principal residences reduced by the deferral.

The basis of either or both spouses' new residences may be reduced. If the basis reduction is divided between both spouses, the basis reduction must be allocated in the same proportion as the couple's basis allocation.

Example 6-15:

- Bill and Denise jointly own their principal residence.
- In January 1997, the couple decides to separate and sell the house for $250,000.
- In the separation agreement, each spouse receives 50% of the sales proceeds ($125,000) and 50% of the house's $200,000 basis.
- Within the §1034 replacement period, Bill and Denise each purchase replacement residences costing $150,000.
  - Because each residence's cost ($150,000) is more than each spouse's share of the old residence's adjusted selling price ($125,000), the couple can defer the total $50,000 gain.
  - In addition, Bill and Denise must each agree to reduce their new residence's basis by one-half ($25,000) of the deferred gain amount.

Problems can arise when divorcing spouses have a §1034 gain deferral, file a joint return and, later, one spouse does not meet §1034's provisions (e.g., does not purchase a replacement residence within the specified time period). In this case, an amended return must be filed to report the deferred gain that must be recognized. In this situation, the spouses are jointly and severally liable for any additional taxes owed, even if only one spouse failed to meet §1034's restrictions [see *Murphy*, 103 TC 311(1994) and PLR 8911015].

TAX PLANNING: NOT MAKING THE §1034(G) ELECTION

Generally, it is beneficial to defer any gain recognition on the sale of a principal residence. However, in some instances, not making the §1034(g) election to treat the couple as one taxpayer for §1034 purposes is beneficial, as demonstrated in the next example.

Example 6-16:

- Bill and Denise are married taxpayers that have $60,000 in expiring net operating losses.
- Their principal residence is owned by Bill and has an adjusted tax basis of $90,000.
- In April 1997, the old residence is sold for $170,000 and a new principal residence is purchased by Denise for $300,000.
    - The couple does not make a §1034(g) election and, so, the same taxpayer does not own and reside in both residences and §1034 does not apply to the sale.
    - The $80,000 gain ($170,000 - $90,000) on the residence sale is offset in part by the $60,000 net operating loss carryover.
    - Denise's basis in the new residence is $300,000, her purchase price.

If Bill and Denise in the example above had made the §1034(g) election and §1034 applied to the sale, the basis of Denise's new home would have been reduced to $220,000 ($300,000 purchase - $80,000 of deferred gain), and the net operating loss would have expired unused.

This example illustrates that sometimes it can be advantageous to structure ownership of a new principal residence to avoid §1034(a)'s mandatory application.

Section 121. Another provision that must be considered when a taxpayer transfers a principal residence is §121. For sales after May 6, 1997, §121 allows a taxpayer to permanently avoid up to $250,000 ($500,000 for a married filing jointly couple) in gain recognition from the sale of his or her principal residence.

See Chapter 1 for a detailed discussion of the §121 exclusion and Chapter 7 for a further discussion of planning involving the §121 election in divorce situations.

INDIVIDUAL RETIREMENT ACCOUNTS

Another asset that is commonly transferred in exchange for a spouse's marital rights is an individual retirement account (IRA). Under §408(d)(6), the transfer of all or part of an IRA to a spouse or former spouse under a divorce decree is a nontaxable transaction. The transferee spouse can roll over any part or all of the distribution to another IRA. However, if any part of the IRA distribution is not rolled over, it is taxable to the transferee spouse and subject to early withdrawal penalties, if the recipient spouse is under age 59½.

LIFE INSURANCE POLICIES

Marital settlements often require spousal transfers of life insurance policies. In some cases, the transfer provides a source of continued support after the insured's death. Life insurance policies may be transferred tax-free under §1041(d).

INSTALLMENT NOTE TRANSFERS

Sometimes there is insufficient cash to satisfy a property settlement. This may necessitate a liquidation of marital assets (e.g., stock in a family business) in a "fire sale" situation which could be economically disadvantageous.

To avoid such situations, a note may be given by one spouse to the other, allowing cash payments over an extended period of time. Typically, an installment note will carry a stated interest rate.

Example 6-17:

- Bill and Denise are divorcing. As part of the property settlement, Bill agrees to make a cash payment to Denise of $2,500,000.
- Bill is to pay $1,500,000 in cash immediately and make five annual payments of $200,000. The $1,000,000 installment obligation carries a market rate of interest.
  - The $200,000 principal payments are tax-free to Denise and nondeductible by Bill under §1041 (the payments are made pursuant to the divorce agreement and completed within six years).
  - While the note's interest payments are taxable income to Denise, they probably do not result in tax deductions for Bill. In most cases, the payments will be viewed as compensation for surrendering marital rights and, consequently, be characterized as nondeductible personal interest.

SUMMARY

In this chapter, we have discussed some considerations in spousal property settlements. Our discussion has centered around §1041, which generally provides that no gain or loss is recognized on asset transfers between spouses. In general, the transferee spouse takes a tax basis in the transferred property equal to the transferor spouse's tax basis. In addition, the transferee spouse's holding period includes the transferor spouse's holding period. This concept of the holding period tacking on is important when qualifying the asset for long-term capital gain treatment on a later sale.

For property distributions to former spouses to qualify for §1041 treatment, the transfers must be incident to a divorce and consist of tangible or intangible property (but not services).

It is sometimes difficult to value spousal property transfers. Because a transferred property's basis carries over from one spouse to the other, a low basis property has an inherent built-in tax liability that must be valued to ensure an equitable distribution.

A summary of the chapter's most important technical points follows.

- Section 1041 generally provides that neither the transferor spouse nor the transferee spouse recognizes any gain or loss on marital property transfers;

- Section 1041 applies to transfers between both married spouses and former spouses, if transfers to a former spouse are made pursuant to a divorce or separate maintenance agreement;

- The transferor spouse's basis of property transferred carries over and becomes the transferee spouse's basis;

- The transferee spouse's holding period in the property received includes the transferor spouse's holding period;

- Transfers to a third party on behalf of the transferee spouse will qualify for §1041 treatment in the following instances:

    - When the third party transfer is required by a divorce or separation agreement;

    - When the third party transfer is pursuant to the spouse's (or former spouse's) written request; or

    - When the spouse (or former spouse) ratifies the transfer to the third party on his or her behalf.

- Spousal property transfers from a controlled entity to the transferee spouse do not qualify for §1041 treatment;

- Section 1041 does not apply to spousal transfers of services; and

- Special §1034(g) allows married (and divorcing) taxpayers to be treated as one person for §1034's principal residence gain deferral provisions, even if one spouse owns the former residence and the other spouse purchases the replacement residence.

CHAPTER 7

PLANNING FOR THE TAX IMPACT OF ENDING A MARRIAGE

INTRODUCTION

In Chapter 1, we discussed the tax consequences and planning opportunities involved in deciding whether and when to marry. Because of the Code's graduated marginal tax rates and the marriage penalty, as was shown in Chapter 1, an individual's marital status may drastically impact his or her income tax liability.

The timing of either divorce or a separate maintenance agreement may influence the tax liability of each party in the year the marriage is terminated. This chapter discusses the tax provisions and decisions involving marital status that should be considered in planning the timing of a divorce and negotiating a settlement agreement.

In addition, a divorce or separate maintenance agreement produces unique tax results. Some of these mutually exclusive results that are discussed in this chapter include:

- Deductibility of attorney's fees;
- Transfer and taxation of employee retirement plans;
- Making estimated tax payments;
- Receiving tax refunds and credits; and
- Estate and gift consequences of property settlements.

MARRIAGE PENALTY

Chapter 1 provided an exhaustive list of the items comprising the marriage penalty. Just as these items may impact a couple's tax liability in the year of marriage, on the flipside, they may have the same effect on the couple's tax liability in the year of divorce. Some of the more important marriage penalty items, previously discussed in Chapter 1 in the context of planning for a marriage, are again discussed in this chapter in the context of planning for a separation and divorce.

INCOME TAX RATES

For most married couples, computing their tax liability on a married filing jointly basis will generally result in the lowest potential tax liability because of the inherent lower tax rates. However, in some instances, the income tax rates may be more favorable for single individuals than for married individuals.

When one of the spouses generates almost all of the taxable income, the married filing jointly tax rates produce an overall lower tax liability than two individual filers. As the second spouse begins to generate 25%–30% of the combined taxable income amount, the married filing jointly rates actually produce a higher tax liability. For two income-earning spouses contemplating divorce, accelerating the divorce into the earliest possible year to secure the lower combined individual tax rates should be considered.

Example 7-1:

- Ken and Barbie, who have been married for ten years, have decided to divorce in late 1997 or early 1998.
- Ken and Barbie's 1997 taxable incomes are $80,000 and $120,000, respectively.
    - If Ken and Barbie finalize their divorce in early 1998 and file a 1997 joint return, according to the chart (60%/40%), the couple would pay $4,223 more in taxes in 1997 than if they filed as two individual taxpayers.

TAX PLANNING

HEAD OF HOUSEHOLD STATUS AND STANDARD DEDUCTION

Strictly for tax planning purposes, it may be beneficial for each divorcing parent to retain legal custody of at least one child so that each parent may potentially enjoy the lower tax rate benefits associated with the head of household filing status. If this tax planning concept is accepted, it may be beneficial for the couple to finalize their divorce before year-end so that each individual can claim head of household filing status.

Example 7-2:

- Ken and Barbie, who have been married for ten years, have two children — Bill, who is eight years old, and Karen, who is six years old.
- On December 31, 1997, Ken and Barbie's divorce decree is finalized with Ken receiving custody of Bill and Barbie receiving custody of Karen.
- Ken and Barbie have maintained records throughout 1997 demonstrating that each has maintained a household for the child of whom they have custody.
  - Both Ken and Barbie should be eligible to claim head of household filing status for 1997.
  - By having this status for 1997, Ken and Barbie will each claim a $6,050 standard deduction (versus a combined $6,900 standard deduction for married filing jointly tax return filers).
  - Assuming a top marginal tax rate of 36%, finalizing the divorce on December 31, 1997 versus January 1, 1998 saves the couple a combined tax amount relating to the standard deduction amount of over $1,800 ($6,050 + $6,050 = $12,100 - $6,900 = $5,200 × 36% = $1,872) in 1997.

PERSONAL EXEMPTIONS

For 1997, a taxpayer may claim a $2,650 deduction amount for himself or herself, for his or her spouse, and for each qualifying dependent [§151(d)]. However, the exemption amount claimed is reduced by 2% for each $2,500 ($1,250 for married persons filing separate returns) by which the taxpayer's adjusted gross income exceeds the "threshold amount." The threshold amount is determined based on the taxpayer's filing status and is as follows for 1997:

• Married filing jointly	$181,800
• Head of household	$151,500
• Individual	$121,200
• Married filing separately	$ 90,900

As we discussed in the case of the standard deduction, married couples filing joint returns have a higher threshold amount than individual return filers, although it applies to two incomes instead of one. The threshold amount for married taxpayers filing jointly is actually $60,600 less than the sum for two individual taxpayers and $121,200 less than the sum for two head of household filers.

Example 7-3:

- Assume the same facts as in Example 7-2, except that both Ken and Barbie have adjusted gross incomes of $151,500.
    - Assuming both Ken and Barbie qualify for head of household filing status, each taxpayer's return will not have their $5,300 ($2,650 × 2) personal exemption amounts reduced.
    - If Ken and Barbie's divorce decree was finalized one day later and they elected to file their 1997 return on a joint return basis, their $10,600 ($2,650 × 4) personal exemption amount would have been reduced by $10,176 ($151,500 × 2 = $303,000 – $181,800 = $121,200 $2,500 = 48 × 2 = 96% × $10,600 = $10,176).
    - Assuming a top marginal tax rate of 36%, finalizing the divorce decree on December 31, 1997, instead of January 1, 1998, saves the couple a combined tax amount relating to the personal exemptions of over $3,600 ($10,176 × 36% = $3,663).

The personal exemption reduction provisions should be kept in mind when negotiating a separation agreement. The fact that the wealthier spouse's exemptions may be eliminated or severely reduced may make it beneficial to allocate the children's dependency deductions to the other spouse, even if the wealthier spouse provides most of the children's support (see Chapter 6 for a further discussion).

MEDICAL COSTS AND REIMBURSEMENTS

Medical costs claimed as itemized deductions on a taxpayer's return are also subject to a limitation based on the taxpayer's adjusted gross income (in this case, adjusted gross income multiplied by 7.5%). Therefore, as discussed above, the timing of a divorce might be changed if there is an imbalance of adjusted gross income and medical expenses incurred between the divorcing spouses which could affect the total tax benefit derived from the medical expenses.

AMOUNTS RECEIVED UNDER AN ACCIDENT AND HEALTH PLAN

Section 105(b) provides for a gross income exclusion for amounts received by an employee as reimbursement of medical expenses under an accident and health plan for the employee and his or her spouse. If, after a divorce, the former spouse continues to be covered under the taxpayer employee's plan through COBRA coverage, any reimbursement amounts received by the employee on behalf of the former spouse are taxable to the employee. To make the taxpayer employee whole, the divorcing parties should provide in the settlement agreement that the reimbursement of the taxpayer's former spouse's medical expenses should be treated as maintenance, taxable to the former spouse.

CHILD CARE CREDIT

Section 21 provides a non-refundable tax credit to taxpayers who maintain a household for their child under the age of 13 and make qualifying payments for the child's care. The amount of the credit is computed as the lesser of:

- The "applicable percentage" (30% reduced by one percentage point, but not below 20%, for each $2,000, or fraction thereof, that the taxpayer's adjusted gross income exceeds $10,000) multiplied by qualifying dependent care expenses (household services, day care services, etc., with the amount limited to the taxpayer's earned income); or

- $2,400 for one qualifying child ($4,800 for two or more qualifying children) multiplied by the applicable percentage.

Only one credit can be claimed per qualifying child [§21(a)(1)]. Therefore, if the parents are divorced, separated or file separate returns, only the custodial parent can claim the child care credit, although both parents may pay for the child care costs. Eligibility to claim the child care credit is generally determined based on which parent can claim the dependency deduction [§21(b)(1)(A) and (B)]. A custodial parent entitled to claim the dependency deduction because of a multiple support agreement is entitled to claim the child care credit (see the discussion in Chapter 6).

Example 7-4:

- Ken and Barbie, who have been married for ten years, have decided to divorce.
- In the settlement agreement, Barbie will receive custody of Bill, their eight-year-old son, and Bill will qualify Barbie for a dependency deduction on her return.
- For the year, Barbie pays $2,000 to a housekeeper to take care of Bill.
- Barbie's and Ken's adjusted gross incomes are $10,500 and $15,000, respectively.
  - On her head of household return, Barbie can claim a child care credit of $560 ($2,000 × 28%).
  - If Ken and Barbie had remained married and filed a joint return, the total credit they could have claimed on their joint return would have been $400 ($2,000 × 20%).

As demonstrated in the above example, the adjusted gross income limitation ($10,000 for the applicable percentage reduction) does not increase whether the taxpayer is single or married. As with the other items discussed above, the timing of a couple's divorce or separation could impact the benefit derived from the child care credit.

OTHER ISSUES TO CONSIDER IN A DIVORCE

A divorce or separation may create unexpected tax outcomes which the parties should think about before finalizing the separation. Some of these potential outcomes are discussed in this section and can be mitigated if properly considered and planned.

DEDUCTIBILITY OF ATTORNEY'S FEES

Generally, legal fees paid by a spouse in connection with a divorce or separation are not deductible because the genesis of such fees is personal ("legal" and "attorney" fees are intended to be generic terms to include accountant fees and any other professional fees related to a divorce). This is true even if the fees are incurred to prevent having to surrender income-producing property as part of the settlement agreement [*U.S. v. Gilmore*, 372 U.S. 39 (1963)].

For divorce-related attorney's fees to be deductible, the fees must qualify under §212 as ordinary and necessary expenses incurred:

- For the production or collection of income;
- For the management, conservation or maintenance of property held for the production or collection of income; or
- In connection with the determination, collection or refund of tax.

The following divorce-related legal fees which are substantiated and clearly identified may be deductible [*J. V. Ellion v. Commissioner*, 40 TC 304 (1963) and *Dalton v. Commissioner*, 34 TC 879 (1960)]:

- Fees incurred to collect unpaid spousal support;
- Fees incurred to modify a court judgment to increase alimony payments;
- Fees incurred to defend against having alimony payments reduced; and
- Fees attributable to tax advice in connection with a divorce.

The following divorce-related legal fees would be nondeductible:

- General fees to file for a divorce;
- Fees incurred to defend against having to make alimony payments; and
- Fees incurred to gain or defend title of property, even if income producing (however, these fees may be capitalized and added to the holder's basis in the property).

Any deductible attorney's fees claimed in a taxpayer's return would be considered miscellaneous itemized deductions, subject to the 2% adjusted gross income limitation.

Retirement Plans

Generally, one of the most valuable assets a married couple possesses, other than their personal residence, is the retirement benefits one or both of the spouses might have earned. Although retirement benefits are owned by the spouse who has worked for them, most state courts believe that a portion of the future retirement benefits should be considered as property subject to settlement. If a portion of the future benefits is allocated to the non-employee spouse, plan disqualification problems may result.

There are two general types of retirement plans:

1. Nonqualified retirement plans; and

2. Qualified retirement plans.

Protecting the nonemployee spouse's interest in the retirement benefits differs depending on whether the plan is nonqualified or qualified.

Nonqualified Plans. The most common type of nonqualified retirement plan that must be considered in planning for a divorce is a deferred compensation plan. Generally, deferred compensation plans are unfunded promises to pay, subject to the good faith of the providing company. Because the plans are generally unfunded, the divorcing parties have two options when dividing the benefits:

1. The nonemployee spouse receives non-plan assets to offset the marital plan rights, with the employee spouse retaining the entire plan interest; or

2. Each spouse receives a portion of the retirement benefits when they are paid by the company in the future.

The nonemployee spouse generally prefers the first option because there will be immediate tangible assets. However, the couple may need to have significant non-retirement assets to trade off against this option.

Qualified Plans. A qualified retirement plan generally includes the following plans:

- A stock bonus, pension or profit-sharing plan;

- An annuity plan or contract; and

- An individual retirement account.

Section 401(a)(13), which only applies to qualified plans, provides that a plan beneficiary cannot, generally, assign his or her retirement benefits without disqualifying the plan. However, §401(a)(13)(B) provides that an assignment of future benefits pursuant to a divorce decree or separate maintenance agreement will *not* disqualify the plan if the assignment is made pursuant to a "qualified domestic relations order" ("QDRO").

A QDRO is any judgment, order or decree (including the approval of a prior property settlement) that:

- Provides child support, alimony or marital property rights to a spouse, former spouse, child or other dependent of the plan participant; and

- Is made pursuant to a state domestic relations law [§414(p)(1)(B)].

A QDRO must contain the following information:

- Name and address of the plan participant and the designated payee;
- The amount or percentage of the plan participant's benefits to be paid to the designated payee;
- How long the order applies; and
- The qualified plans for which the order applies [§414(p)(2)].

The designated payee's taxability of the benefits received under a QDRO are the same as the plan participant's; the designated payee steps into the plan participant's shoes. Similarly, if a spouse has an IRA, it can be transferred to the spouse tax free as part of the divorce settlement [§408(d)(6)].

SPOUSAL IRA

Alimony payments received as part of a divorce settlement agreement are treated as compensation for IRA purposes. Therefore, it may be beneficial to treat a portion of a property settlement as alimony, allowing the recipient spouse to build an IRA for the future.

Example 7-5:

- Ken and Barbie, who have been married for ten years, divorced.
- As part of the settlement agreement, Barbie agrees to pay Ken $2,000 per year, terminating on Ken's death.
    - Because of this termination clause, the $2,000 per year payment will be treated as alimony, deductible by Barbie and taxable to Ken.
    - Because alimony is treated as compensation, ignoring any other income, Ken may contribute $2,000 per year to an IRA, allowing him a $2,000 annual IRA deduction assuming he meets the requirements for a deductible IRA.
    - By structuring a part of the settlement payment as alimony, Barbie will receive a $2,000 deduction and Ken will have no incremental taxable income, net of the IRA deduction.

ESTIMATED TAX PAYMENTS

It is common for new alimony recipients to be unaware of potential estimated tax requirements. Generally, individual taxpayers must prepay at least 90% of their actual current year income tax liability on a timely basis to avoid penalties. An individual's actual current year income tax liability may be prepaid by:

- Having the taxes withheld; or

- Making estimated tax payments.

In regard to alimony received, a taxpayer will generally prepay the required taxes owed by making estimated tax payments. However, a taxpayer may have additional taxes withheld from other earned income sources to provide for any anticipated tax shortfall created by the receipt of alimony.

Individual taxpayers having a December 31 year-end are required to make estimated tax payments four times during the year on the following dates:

- April 15;
- June 15;
- September 15; and
- January 15 of the following year.

The estimated tax liability to be paid in must include the taxpayer's estimated liability for self-employment tax.

Any underpayment of estimated taxes is subject to a nondeductible penalty computed as interest. Generally, the underpayment of estimated taxes penalty may be avoided if:

- 100% (110% for certain high income individuals) of the taxpayer's previous year tax liability is paid in during the current year on a timely basis; or

- The current year estimated tax payments (90% of current liability) are made on an annualized basis which considers when income was earned during the year.

In the year of separation, the rules regarding estimated tax payments and penalty avoidance become a bit more complicated because:

- The prior year's tax return was probably filed on a joint return basis; and

- Any estimated tax payments may have been made during the year on a joint basis.

In this situation, the following items should be considered in making the estimated tax payments for the year:

- To avoid the underpayment of estimated taxes penalty by using the prior year's tax liability exception, if the taxpayer is filing a current year separate return, but filed a prior year joint return, the penalty will be avoided if the current year estimated tax payments equal the lesser of:

    - The tax shown on the prior year return; or

    - A portion of the prior year's tax liability as if the joint taxpayers filed separate returns (as computed using the formula discussed in the next section, "Tax Refunds and Credits") [Reg. §1.6654-2(e)(1)].

- If joint estimated tax payments are made in the year of separation, the IRS will, generally, credit the payments to the taxpayer whose Social Security number appears first on the voucher; and

- If joint estimated tax payments are made out of community property funds, the estimated payments should be listed as community property assets in the property settlement agreement.

TAX REFUNDS AND CREDITS

If a married couple who are due a refund for a previously filed joint return year separate prior to receiving the refund check, there may be problems in dividing the refund. It is clear that the refund is the property of the spouse whose tax liability and estimated tax payments created the refund [Rev. Rul. 74-611, 1994-2 CB 399]. A joint return filing does not convert one spouse's tax liability or overpayment into the tax liability or overpayment of the other spouse [*Dolan v. Commissioner*, 44 TC 420 (1965)].

The only problem is determining each spouse's portion of the joint overpayment. Revenue Ruling 80-7 [1980-1 CB 296] provides the following two-step process for calculating each spouse's overpayment amount.

Step 1: Determine each spouse's separate liability.

Each spouse's separate tax liability may be computed using the following formula:

$$\frac{\text{Spouse's separate tax}}{\text{Both spouses' separate tax}} \times \text{Joint tax liability}$$

Example 7-6:

- Ken and Barbie, who have been married for ten years, divorce in 1997. In 1997, Ken and Barbie filed a joint return for 1996 reflecting the following tax calculations:

	Ken	Barbie	Total
Income	$40,000	$50,000	$90,000
Standard Deduction			(6,700)
Exemptions			(5,100)
Taxable Income			$78,200
Tax			$16,683

- Ken and Barbie's separate tax liability, computed as if they filed on a married filing separate return basis, would have been calculated as follows:

	Ken	Barbie
Income	$40,000	$50,000
Standard Deduction	(3,350)	(3,350)
Exemption	(2,550)	(2,550)
Taxable Income	$34,100	$44,100
Tax	$ 6,942	$ 9,741

- Therefore, Ken's and Barbie's portion of their joint 1996 tax liability is computed as follows:

Ken:

$$\frac{\$\,6{,}942}{\$16{,}683} \times \$16{,}683 = \underline{\underline{\$6{,}942}}$$

Barbie:

$$\frac{\$\,9{,}741}{\$16{,}683} \times \$16{,}683 = \underline{\underline{\$9{,}741}}$$

- Although Ken provided 44.4% of the couple's total income ($40,000/$90,000), Ken's allocable share of the joint tax liability, 41.6% ($6,942/$16,683), is different because Ken is entitled to the $2,550 exemption and one-half ($3,350) of the couple's standard deduction.

Step 2: Determine each spouse's actual estimated tax payments (including withholding).

Each spouse's actual tax overpayment is determined by subtracting each spouse's actual tax payments from Step 1's computed joint tax allocation.

Example 7-7:

- Assume the same facts as in Example 7-6, except that Ken and Barbie had taxes withheld in 1996 of $7,200 and $10,300, respectively.
  - Ken and Barbie's tax refund amount is $817, with Ken receiving $258 ($7,200 - $6,942) and Barbie receiving $559 ($10,300 - $9,741).

Example 7-8:

- Assume the same facts as in Example 7-6, except that Ken and Barbie had taxes withheld in 1996 of $6,800 and $10,700, respectively.
  - Ken and Barbie's tax refund amount is $817, with Barbie receiving the entire amount.

If a married couple have made joint estimated tax payments, it may be difficult to trace the cash source. If no allocation is possible, the payments should be prorated to each spouse based on the formula used in Step 1 above.

Example 7-9:

- Assume the same facts as in Example 7-8, except that the couple made an additional $1,000 of estimated tax payments in 1996.
  - Absent any agreement, Ken is deemed to have made $416 ($1,000 × 41.6%) of the estimated tax payments and Barbie is deemed to have made $584 ($1,000 × 58.4%).
  - Therefore, Ken and Barbie's tax refund amount is $1,817, with Ken receiving $274 ($7,216 - $6,942) and Barbie receiving $1,543 ($11,284 - $9,741).

GIFT AND ESTATE TAX CONSEQUENCES

The gift and estate tax represent a single transfer system. The two taxes work in tandem to tax transfers of property for less than full and adequate consideration. The requirements for determining whether a transfer is a taxable gift are generally the same as the requirements for determining whether the property transferred is included in the taxpayer's estate.

GIFT TAX

A transfer incident to divorce under §1041 is treated as a gift for income tax purposes [§1041(b)(1)]. However, a gift for income tax purposes does not necessarily result in a gift for gift tax purposes [§2501(a)(1)]. For §2501(a)(1) purposes, a gift is any transfer of property for less than full and adequate consideration. The amount of the gift is equal to the excess of the value of the property transferred over the value of the consideration received [§2512(b)]. So, there is no taxable gift if the value of the property transferred equals the value of the consideration received.

Applied literally, §2512 would appear to treat all divorce-related transfers as taxable gifts. However, through the years, Congress and the courts have established the following gift tax exceptions in which the divorce-related transfers are for full and adequate consideration:

- Distributions "deemed" to be for full and adequate consideration;
- Distributions subject to a court decreed exemption; and
- Distributions in satisfaction of support obligations.

Deemed Adequate Consideration. A divorce-related transfer will be deemed made for adequate consideration and, thus, not subject to gift tax if:

- The transfer is made pursuant to a written agreement relating to marital and property rights;
- A final divorce decree has been received within one year before or two years after the written agreement has been entered into; and
- The transfer settles all property or marital rights or provides an allowance to support the couple's minor children [§2516].

The divorce-related transfer does not have to be made within any prescribed time limit as long as the ultimate transfer is made pursuant to a written agreement that is entered into within the three-year time span encompassing the divorce.

If a transfer is made that is intended to qualify under §2516's exception and the divorce has not yet occurred, a gift tax return must be filed with a copy of the written agreement attached. Within 60 days of receiving the final divorce decree, a certified copy of the decree must be filed with the IRS office receiving the gift tax return.

Example 7-10:

- Ken and Barbie have decided to divorce and on October 31, 1997, enter into a written settlement agreement detailing each other's marital and property rights.
- As part of the settlement agreement, Ken transfers $75,000 of property to Barbie.
- Ken and Barbie receive their final divorce decree on March 15, 1998.
    - Ken must file a gift tax return for 1997 (see the later discussion of the unlimited gift tax marital deduction). Ken must attach a copy of the written settlement agreement with the gift tax return.
    - In addition, by May 14, 1998, Ken must send a certified copy of the final divorce decree to the IRS office in which the gift tax return was filed.

Court Decree Exemption. When a court has the power to dictate the terms and allocation of the property and marital rights settlement, the property transfer subject to such settlement is deemed made for full and adequate consideration and is not subject to gift taxes.

Satisfaction of Support Obligations. Divorce-related property transfers made in exchange for the relinquishment of support rights are deemed made for full and adequate consideration to the extent of the value of the support rights surrendered. The problem with relying on this gift tax exception is the uncertainty in determining the value of the support rights that are surrendered. The IRS has ruled that the support rights valuation will be made on a facts and circumstances basis.

Statutory Gift Tax Exceptions. In addition to the above gift tax exceptions specifically mandated for divorce-related transfers, the Code provides other gift tax exceptions that, although not specifically solely encompassing divorce-related transfers, may be applied to these types of transfers. These statutory gift tax exceptions include the following:

- $10,000 annual gift tax exclusion;

- Direct payment of tuition and medical expenses exclusion; and
- Unlimited gift tax marital deduction.

$10,000 Annual Gift Tax Exclusion. The first $10,000 of taxable gifts a donor makes to any individual during the year is not included in the donee's taxable gifts for the year [§2503(b)].

Example 7-11:

- Three years after their divorce, Ken gives Barbie a truck valued at $10,000 which he received in the divorce.
  - Assuming Ken makes no other gifts to Barbie during the year, the truck's gift will be entirely sheltered by the $10,000 annual exclusion and not subject to gift tax.

EDUCATIONAL GIFTS TO ADULT CHILDREN

The primary benefit of §2503(b)'s annual exclusion in divorce situations is to exempt from gift taxes any college and other payments made to the couple's adult children. Oftentimes, college and living costs for adult children are detailed items in a property settlement arrangement. As discussed below, under §2503(e), direct tuition payments are exempt from gift tax, but, otherwise, payments made to or for the benefit of adult children, including educational expenses, are subject to gift taxes.

Direct Payment of Tuition and Medical Expenses. Under §2503(e), payments made directly to:

- An educational institution; or
- A medical care provider (including an insurance company)

for the benefit of an individual are not subject to gift tax. However, any payments for related items, such as for books, room and board or tuition and medical expenses reimbursements are subject to gift tax. Because the educational and medical expenses must be paid directly to the provider, payments to a trust for the beneficiary's ultimate use do not qualify for the annual exclusion.

Example 7-12:

- Ken and Barbie, who are separated, have a son, Bill.
- In 1995, Ken and Barbie enter into a separate maintenance agreement in which Barbie agrees to pay for Bill's college tuition, books and room and board.
- In 1997, Ken and Barbie enter into a final divorce decree which does not incorporate the separate maintenance agreement.
- In 1998, when Bill is 22 years old, Barbie pays Bill's $25,000 tuition directly to the university and also gives Bill $20,000 for college living expenses.
    - The $25,000 Barbie pays to the university for Bill's tuition is not a taxable gift because the payment is made directly to an educational organization.
    - However, the $20,000 payment to Bill for living expenses is a taxable gift and may be reduced by the $10,000 annual gift tax exclusion.

Unlimited Gift Tax Marital Deduction. Under §2523(a), the value of property transferred to a spouse is not considered a taxable gift. However, to receive the unlimited exemption, the couple must be married at the time of the property transfer.

While §2523(a) is not specifically a divorce provision, it provides the largest loophole for divorcing couples to avoid gift tax treatment. Generally, in most divorces, the settlement of marital issues and the actual property transfers occur during the separation period, while the parties are still married. Because of this, the spouses need not worry whether the transfers are taxable gifts because of the unlimited marital exemption.

ESTATE TAX

An estate tax is assessed on a taxpayer's taxable estate at death and on all taxable gifts (exceeding the $10,000 annual exclusion) made during the taxpayer's life. In addition, debts of and claims against the taxpayer are deductible by the estate in arriving at the estate's taxable value for estate tax purposes.

Example 7-13:

- Ken and Barbie divorced in 1991 after 25 years of marriage.
- As part of the written separate maintenance agreement, Ken agreed to pay Barbie $600,000, with the payments to be made in $60,000 installments for ten years.
- Ken has made taxable lifetime gifts to his children and grandchildren totaling $250,000.
- Ken dies during 1997 with a net asset value included in his estate of $800,000. The discounted present value of Ken's remaining payments to Barbie at the time of his death is $150,000.
  - Ken's taxable estate includes the following items:
    - Net asset value at time of death of $800,000; plus
    - Lifetime gifts exceeding the $10,000 annual gift tax exclusion of $250,000; minus
    - The discounted present value of Ken's liability of $150,000 to Barbie.

Example 7-14:

- Assume the same facts as in Example 7-13, except that Barbie dies in 1997.
  - If Barbie's estate has the right to collect the ongoing yearly payments from Ken, then the obligation's $150,000 present value would be included in Barbie's taxable estate.

SUMMARY

In discussing the life cycle of a marriage, this chapter should be viewed as a corollary to Chapter 1. In Chapter 1, we discussed the tax advantages and disadvantages (the "marriage penalty") of entering into a marriage. In this chapter, we have discussed planning the timing of a separation or divorce to save taxes.

It is generally advantageous for tax reasons to terminate a marriage prior to year-end because of the marriage penalty. The various income and tax limitations on some deductions make it beneficial to have two limitations instead of one.

A summary of the chapter's most important technical points follows.

- Because of the marriage penalty, married couples planning to divorce may receive greater tax benefits from the following items if they terminate their marriage before year-end:

    - Income tax rates;
    - Personal exemptions;
    - Medical costs;
    - Section 121 exclusion; and
    - Child care credit.

- Attorney's fees incurred incident to a divorce are generally nondeductible because they are personal in nature. However, certain fees, such as those incurred to collect unpaid spousal support or fees incurred for tax advice in connection with a divorce may be deductible, subject to the 2% adjusted gross income limitation;

- An employee spouse may, generally, assign an interest in a retirement benefit to the non-employee spouse in a divorce without disqualifying the plan;

- Alimony payments received are subject to taxation and, thus, estimated tax payments should be considered;

- If a married couple that is due a refund for a previously filed joint return year separate before receiving the refund check, the refund is the property of the spouse whose tax liability and estimated tax payments created the refund;

- Generally, if properly structured, divorce-related property transfers should result in no gift tax liability; and

- Continuing divorce-related obligations are included in the recipient taxpayer's estate, and are treated as a reduction in the obligor taxpayer's taxable estate when he or she dies.

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